Changing for the Better

THE LONG-TERM CASE FOR EMERGING MARKETS

Emerging markets are undergoing fundamental change. Economies that were once dominated by agriculture and low cost manufacturing are now home to some of the world’s most innovative companies, such as China’s Alibaba and Korea’s Samsung Electronics. Emerging markets workers’ wages are also improving and their spending patterns are shifting. These factors are a gamechanger for long-term investors. In fact, we believe the favorable future of emerging markets combined with its relative discount to developed markets makes the asset class an essential long-term component of investors’ portfolios.
Emerging Markets Have Evolved

Emerging markets countries have worked hard to diversify their economies. The asset class is moving away from low cost, labor intensive industries and towards higher-paying service-oriented ones. Technology, which only represented 2% of the MSCI Emerging Markets Index in 1995, is now the largest sector in the emerging markets with a 28% weight. On the other hand, materials, which once accounted for 20% of the index in 1995, only represents 7% today.

As of 31 March 2018
MSCI Emerging Markets Index
Source: Bloomberg, MSCI
Emerging Markets Drive 60% of Global Growth...

Emerging markets represent nearly 60% of global growth. China alone accounts for 20% of global growth, up from just 2% in 1980. Although emerging markets’ contribution to global growth continues to rise, as a percentage of GDP, its market cap is still only one-fourth the size of developed markets’ market cap. Going forward, we expect this share to grow as restrictions on foreign investment are relaxed and emerging economies continue to expand.

Emerging Markets’ Share of Global GDP (PPP)

As of 18 April 2017
Source: Credit Suisse, Haver Analytics, International Monetary Fund

...and Have a Strong Long-Term Growth Outlook

Global growth began to pick up in 2016 and continued to trend upwards throughout 2017. This is a tailwind for emerging markets companies as this should increase demand for their goods and services. As emerging countries continue to restructure their economies, annual real growth could surpass 5% over the next five years. This is about 3% more than developed markets.

Emerging Markets Growth Is Expected to Pick Up

As of April 2018
Data: GDP (constant prices, p.a. % change).
Forecasted or estimated results do not represent a promise or guarantee of future results and are subject to change.
Source: Haver Analytics, International Monetary Fund
The Emerging Markets Middle Class Is Growing

The evolution of emerging markets industries has given rise to the emerging markets middle class, which is expected to represent 58% of the world’s middle class population by 2030. China and India’s middle class is expected to reach nearly 800 million and will represent two of the top three largest middle class populations in the world by 2020. A growing middle class typically helps fuel economic growth. By 2025, annual emerging markets consumption is expected to reach $30 trillion, nearly half of the global total, up from $12 trillion in 2010. Going forward, global consumption will increasingly be dominated by the emerging markets middle class.

The Global Middle Class Size—Size and Consumption Will Likely Be Dominated by EM

Middle Class Population as a Percentage of the Global Total

<table>
<thead>
<tr>
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<th>2009</th>
<th>2020E</th>
<th>2030E</th>
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<tbody>
<tr>
<td>Middle Class Population: 1,845 million</td>
<td>27%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Middle Class Population: 3,249 million</td>
<td>42%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Middle Class Population: 4,884 million</td>
<td>58%</td>
<td></td>
<td></td>
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<tr>
<td>Other</td>
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Largest Country by Middle Class Consumption*, ($T)

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<tr>
<th></th>
<th>2009</th>
<th>2020E</th>
<th>2030E</th>
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<tbody>
<tr>
<td>United States Total Middle Class Consumption</td>
<td>$4.4</td>
<td></td>
<td></td>
</tr>
<tr>
<td>China Total Middle Class Consumption</td>
<td>$4.5</td>
<td></td>
<td></td>
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<tr>
<td>India Total Middle Class Consumption</td>
<td>$12.8</td>
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</tbody>
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* Based on 2005 PPP US dollar

Estimated or forecasted data are not a promise or guarantee of future results and are subject to change.

Spending and Consumption Patterns Are Changing

Over the past decade, improving job prospects and salaries have shifted the spending patterns of emerging markets consumers. As incomes rise, and economies become more developed, consumers are able to spend beyond basic necessities. Today, emerging markets consumers are spending a larger percentage of their income on services such as education, health care, entertainment, and travel.

Emerging Markets Have the Lowest Level of Debt

Emerging markets, as a whole, have less debt than do developed markets, debunking the common misperception that emerging markets countries are heavily indebted. In fact, as of the end of 2016, emerging markets’ share of total global debt was only 18% and more than 85% of this debt was domestic (local currency) debt, making them less vulnerable to external currency shocks.
The Active Advantage

Security selection is crucial for driving performance. Active managers have the advantage of going beyond an index to tap into the growing emerging markets opportunity set. In fact, active managers can choose from over 2,500 listed emerging markets companies, while ETFs and index funds are limited to the 850 stocks in the MSCI Emerging Markets Index. In addition, unlike ETFs or index funds, active managers can overweight, underweight, or avoid securities they deem unfit for a portfolio. We believe this is crucial to generating consistent long-term outperformance.

EM Active Managers Outperform over the Long Term

As of 31 December 2017. All data run on 6 February 2018.
eVestment Universe – Emerging Markets Equity. There are 67 passively managed products removed from this universe in order to generate active managers performance. Performance is calculated using monthly performance. Performance is presented gross and net of all fees. Using performance as reported in eVestment, certain managers report net versus gross as their default. The performance quoted represents past performance. Past performance is not a reliable indicator of future results.
Source: eVestment
Access the New Emerging Markets at a Discount

Despite offering a significant growth premium and improving fundamentals, emerging markets companies still trade at a near 30% discount to those in developed markets.

MSCI Emerging Markets Index Valuation

![Graph showing valuation discount/premium over time]

As of 31 March 2018
Trailing 12-month price to earnings
Source: Lazard, MSCI

We see compelling valuation opportunities in this asset class at a time when many emerging markets countries have improved their economic standing and many companies are making meaningful, positive changes to their operating models. We believe the asset class is an essential long-term component of investors’ portfolios, and today may be an opportune entry point.
Important Information

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An investment in bonds carries risk. If interest rates rise, bond prices usually decline. The longer a bond’s maturity, the greater the impact a change in interest rates can have on its price. If you do not hold a bond until maturity, you may experience a gain or loss when you sell. Bonds also carry the risk of default, which is the risk that the issuer is unable to make further income and principal payments. Other risks, including inflation risk, call risk, and prepayment risk, also apply. High yield securities (also referred to as “junk bonds”) inherently have a higher degree of market risk, default risk, and credit risk. Securities in certain non-domestic countries may be less liquid, more volatile, and less subject to governmental supervision than in one’s home market. The values of these securities may be affected by changes in currency rates, application of a country’s specific tax laws, changes in government administration, and economic and monetary policy. Emerging markets securities carry special risks, such as less developed or less efficient trading markets, a lack of company information, and differing auditing and legal standards. The securities markets of emerging markets countries can be extremely volatile; performance can also be influenced by political, social, and economic factors affecting companies in these countries. Derivatives transactions, including those entered into for hedging purposes, may reduce returns or increase volatility, perhaps substantially. Forward currency contracts, and other derivatives investments are subject to the risk of default by the counterparty, can be illiquid and are subject to many of the risks of, and can be highly sensitive to changes in the value of, the related currency or other reference asset. As such, a small investment could have a potentially large impact on performance. Use of derivatives transactions, even if entered into for hedging purposes, may cause losses greater than if an account had not engaged in such transactions.

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