ROTHKO

MONDRIAN INVESTMENT PARTNERS LIMITED

Emerging Markets ('EM'): Fortune Favors the Different

Quarter 4, 2019

In the 2020s, fortune will likely favor differentiated strategies and decisive allocators. We believe it is time to make some hard decisions:

- **Crowded trades have continued to unwind in EM for Traditional-Quants**
  … Lower and more volatile returns from stock selection factors
- **Herding in fundamental EM strategies is now a dangerous distortion**
  … Driven by behavioral biases that show no let up: "the winner takes all"

Most active strategies can be replicated with semi-passive ETFs, most fundamental strategies hold the same basket of stocks, and most quants have seen the basis of their returns – factors – upended (as we predicted). The answer is obvious: Diversify away from convergent strategies, and fast.

EM in 2019: A Year of 3 stocks

In many ways, 2019 was similar to 2017, in that a tight group of closely held names dominated EM returns. It was a tough year for investors that did not succumb to herding into these names. But herding has a habit of reversing sharply…

TSMC, Alibaba and Samsung are the stocks in question. All three are excellent companies and dominant in their competitive landscapes. Fortunately, asset allocators were well exposed to these stocks, for what could turn out to be the unfortunate reason that many of their managers have large and concentrated holdings to them. In fact, pretty worryingly, fundamental EM strategies now have an average overlap to the same names of 31% of their portfolios. This same figure was only 6% in 2015. This growth in overlap is the result of a dangerous behavioural bias: herding. We will hear more about this effect later but it leaves an awkward question for allocators. Are you served by undifferentiated strategies, tied to the same basket of names? We believe the answer is "no".

Exhibit 1: Quants Converge; Fundamental Drift

Largest 15 EM Quant returns; Largest 15 EM Fundamental returns

Five-year relative return (annualised)

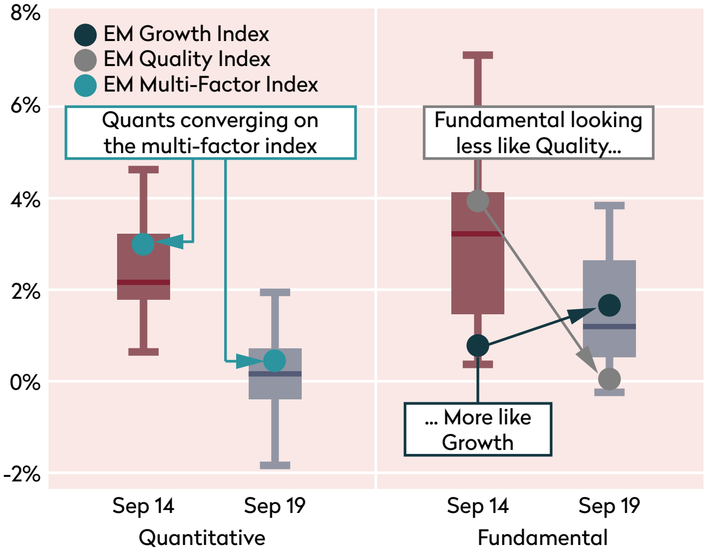
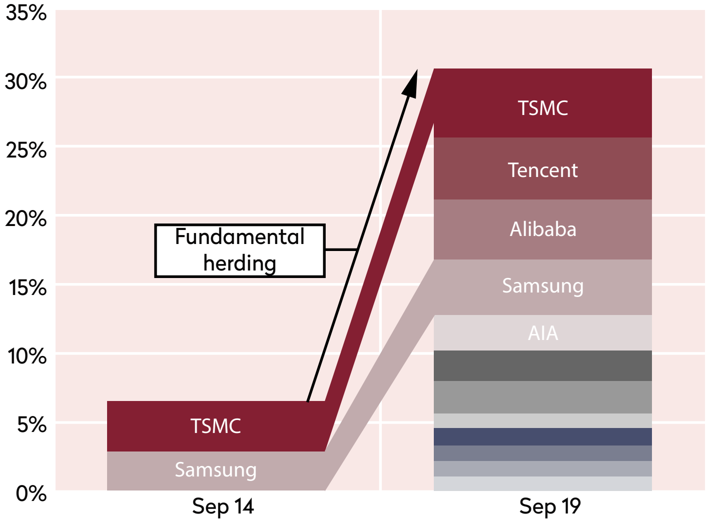


Exhibit 2: Fundamental Herding

Names held by over two-thirds of fundamental managers

2014 vs 2019



Source: eVestment, Factset, Rothko.

Notes: The top 15 quantitative and top 15 fundamental strategies by AUM as of September 2019 in the eVestment Global Emerging Markets universe. These strategies accounted for 82% and 47% of AUM within their respective investment approaches.

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Quant Crowd Versus Fundamental Herd

2019 was the most rational year of the 2010s in traditional-quant's factor-driven investing, and the least rational year of the decade in fundamental investing. Traditional-quants (who use factors and assumptions of linearity to invest) continued to struggle in 2019, owing to the misfiring of factor trades as factors violently flipped, correlation structures remained compromised and mechanistic rebalancing whipsawed the performance of the largest quant firms.

Mega-quant's suffer gravitational force towards passive

Where the massive AUM of large quant firms used to be an advantage, it has now become a gravitational force pulling all the mega-quants towards semi-passive benchmark returns (e.g. MSCI EM Diversified Multi-Factor Index and other style factors). There are few traditional-quants that add much (if any) return above these indices now (see Exhibit 1, left side).

Fundamental stock overlap huge and growing

While factor trades damagingly unwound in the quant world, the herding continued to build risks in fundamental. This is made clear by the extent of the overlap in the top 15 largest fundamental portfolios in EM. While the overlap among the largest EM fundamental strategies had an average 6% overlap from two names back in 2015, this now makes up a 31% overlap made up of 11 names today (see Exhibit 2). The overlap in holdings is quite astonishing. It not only ties the largest fundamental managers' fates together, but it also cues up an unwind of proportions that could exceed those that traditional-quants suffered in the last 18 months. The solution is obvious: Diversify away from convergent strategies, and fast.

A deeper search for truly different strategies

So where to invest? Traditional-quants are compromised and fundamental strategies have herded. And with passive investing being a poor option in EM, the answer has compelled a deeper search for truly different strategies. Allocators need, more than ever, to cut through the marketing piffle to find strategies that: 1) are not replicable using cheap style factors, 2) will diversify a plan while generating true alpha (uncorrelated returns), and 3) are unlikely to be exposed to the unwinding of crowded trades that will surely come. But of course, this is easier said than done.

Rothko: Fortunately Different

As quant's traditional-factor trades unwind and fundamental strategies' herding reaches dangerous levels, fortune in the 2020s will favor strategies that can differentiate themselves. Unfortunately, for allocators, the status quo in the 2020s will bring more fake "active returns" that can be replicated by factors indices, more herding, less differentiation and lower levels of alpha. A casual glance at EM managers' holdings data indicates this will be so. For this reason, fortune will favor differentiated strategies and decisive allocators in the 2020s.

We believe that it is the beginning of the end for managers providing cheap-beta for active fees. In quantitative investment management, investing is now about alpha, driven by better fundamental stock selection. For this reason, we believe Rothko represents an excellent opportunity to capitalize on this change.

Disclosure

Views expressed were current as of the date indicated, are subject to change, and may not reflect current views.

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Disclosure — Rothko Emerging Markets All Cap Equity

Annual Performance

Year	Total Gross USD Return (%)	Total Net of Fees USD Return (%)	Benchmark USD Return (%)	Composite Standard Deviation (%)	Benchmark Standard Deviation (%)	Number of Portfolios	Composite Dispersion	Total Composite Assets (USD millions)	% of Firm Assets	Total Firm Assets (USD millions)
2013	-1.15	-1.32	1.83	N/A	N/A	1	N/A	8.1	0.01	70,356
2014	0.32	-0.38	-2.19	N/A	N/A	1	N/A	8.1	0.01	64,102
2015	-10.92	-11.54	-14.92	N/A	N/A	1	N/A	7.2	0.01	56,857
2016	18.52	17.70	11.19	16.04	16.07	1	N/A	8.5	0.01	59,033
2017	28.56	27.67	37.28	15.65	15.35	1	N/A	10.9	0.02	62,751
2018	-10.93	-11.55	-14.57	13.61	14.60	1	N/A	6.1	0.01	47,789
2019	13.58	12.79	18.42	12.10	14.17	2	N/A	12.6	0.02	54,401

Accompanying Notes Concerning Performance Calculation and GIPS Compliance

- This composite was created in October 2013.
- Past performance is not a guarantee of future results.
- A complete list and description of all firm composites is available on request.

Mondrian Investment Partners Limited ("Mondrian") claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the Global Investment Performance Standards (GIPS®). Mondrian has been independently verified for the periods 1 January 1993 to 31 December 2018.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS standards.

The Firm is defined as all discretionary portfolios managed by Mondrian.

Mondrian is a value-oriented defensive manager seeking to achieve high real returns for its clients. Mondrian equity mandates apply one of two styles: 'Mondrian' portfolios invest mainly in securities where rigorous dividend discount analysis identifies value in terms of the long-term flows of income. Mondrian's methodology is applied consistently to markets and individual securities. 'Rothko' portfolios are designed to be value-orientated with defensive characteristics.

The Rothko Emerging Markets All Cap Equity Composite includes US dollar based discretionary fee paying portfolios, measured against the Morgan Stanley Capital International EM or equivalent Index net of US withholding taxes. The portfolios are invested primarily in publicly traded companies based in an Emerging Market, or deriving a majority of revenue within Emerging economies. Shares may, however, be listed on more developed exchanges.

Since inception to date, the Rothko Emerging Markets All Cap Equity Composite has consisted only of seed capital portfolios, which were non-fee paying and had no external investors.

Portfolios are valued on a trade date basis using accrual accounting. Returns are calculated using the modified Dietz method and then weighted by using beginning-of-period market values to calculate the monthly composite returns. Portfolio returns are calculated net of irrecoverable withholding tax on dividend income. New portfolios are included in the first full month of investment in the composite's strategy. Terminated portfolios remain in the composite through the last full month of investment. Additional information regarding the valuing of portfolios, calculating performance, and preparing compliant presentations are available upon request.

Composite and benchmark standard deviation are measured as the rolling 3 year annualised standard deviation of monthly returns. The dispersion of annual returns of portfolios within the composite (Composite Dispersion), is measured by the standard deviation of the equal-weighted returns of portfolios represented within the composite for the full year. Composite Dispersion is not presented if there are less than five portfolios in the composite during the year.

Performance results marked "Gross" do not reflect deduction of investment advisory fees. Investment returns will be reduced accordingly. For example, if a 1.00% advisory fee were deducted quarterly (0.25% each quarter) and the three year gross annual returns were 10.00%, 3.00% and -2.00%, giving an annualized return of 3.55% before deduction of advisory fees, then the deduction of advisory fees would result in three year net annual returns of 8.91%, 1.98% and -2.97% giving an annualized net return of 2.52%.

Performance returns marked "Net" reflect deduction of investment advisory fees and are calculated by deducting a quarterly indicative fee from the quarterly composite return. The indicative fee is defined as being the effective fee rate (or average weighted fee) at the composite's minimum account size as set out below. Actual net composite performance would be higher than the indicative performance shown because some accounts have sliding fee scales and accordingly lower effective fee rates.

Mondrian's investment advisory fees are described in Part II of its Form ADV. A representative United States fee schedule for institutional accounts is provided below, although it is expected that from time to time the fee charged will differ from the below schedule depending on the country in which the client is located and the nature, circumstances requirements of individual clients. Net performance in the table above calculated using the following representative fee scale: the first US$50m at 0.70%; the next US$50m at 0.60%; thereafter at 0.50%. Minimum segregated portfolio size is currently US$50 million (or fees equivalent thereto).