

Revenge of the False Monikers

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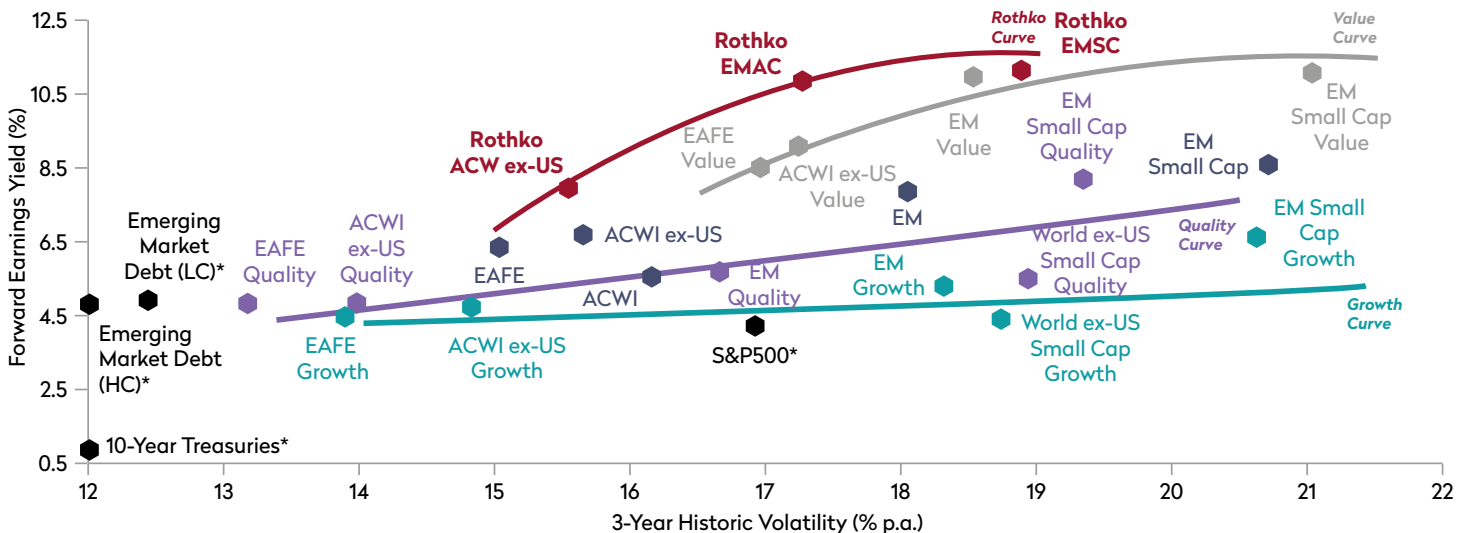
The opportunity in Emerging Markets (EM) Small Cap equities remains one of the most compelling stories in international equities, while taking false monikers at face value, “active” and “all cap”, could cost allocators dear. We note that Rothko’s income-oriented strategies now represent the efficient frontier, making them more compelling now, than ever.

In this piece:

- 1. The New Efficient Frontier:** On a forward-looking basis, income-oriented strategies represent *the* efficient frontier in international equities investing while Growth, particularly at the riskier end of the curve, looks like a poor bet.
- 2. EM Small Cap Flashing “Buy”:** The wall of central bank money is creating huge distortions as the biggest boats rise most on the money tide. The effect: an improbably pessimistic scenario priced in for EM Small Cap, presenting a possible intergenerational investment opportunity. We find affirmation in both fundamentals and credit markets.
- 3. False Monikers, the Risk of Missing Out:** Allocators are well aware of the decline of active share in the purportedly “active” and “all cap” universe of Emerging Markets strategies. Ignoring these false monikers could risk an unforgivable fate: missing out on a potential alpha surge from an EM Small Cap recovery.

Exhibit 1: Rothko: The Efficient Frontier

Forward Earnings Yield vs. 3-Year Volatility



*All indices shown are MSCI with the exception of S&P500, Emerging market debt (LC and HC), 10-year treasuries.

Forward earnings yield for Rothko is calculated using analyst estimates for Earnings Per Share (EPS). For Rothko Emerging Markets All Cap, 30 stocks did not have EPS estimates; the portfolio earnings yield was calculated using the remaining securities and pro-rating their weights (84% of portfolio). For securities where there are no EPS estimates, the portfolio earnings yield was calculated using the securities where EPS estimates were available and pro-rating their weights. EPS estimates were available for 86%, 75% and 99% of Rothko Emerging Markets All Cap, Rothko Emerging Markets Small Cap and Rothko ACW ex US, respectively. 10-year treasuries volatility = 5%. Emerging market debt (HC) volatility = 10%.

Sources: MSCI, iShares, FactSet, Rothko Investment Strategies.

1. The New Efficient Frontier

Equity markets are still guessing at the fundamental outcomes of the coronavirus shock, and one guess looks set to be very wrong in our view: the deep discounts we see across EM Small Cap equities. Small caps are acutely undervalued, even resilient, income-oriented names. It is in these names that we see the most significant intrinsic value available in international equities markets today. The point could not be made any clearer than the pricing of forward earnings we are seeing (see Exhibit 1).

The efficient frontier is Rothko

The most striking observation is the curve created by Rothko’s international and EM equities strategies. In fact, Rothko now represents the efficient frontier in this respect. While Value, as naively defined by MSCI, seems fairly compelling, it also comes with significantly greater risk (note the upper right, more risky location of the Value curve). Also notable is the unattractiveness of Growth on this measure, with not just historically low forward earnings yields, but also a relatively flat curve, showing that there is little to separate the more risky Growth assets from the less risky ones. This, in turn, raises questions as to the wisdom of investing far out on this Growth risk-curve.

We note that Rothko, as an income-oriented approach, comes with similar levels of forward earnings yields to that of Value, but with much less overall realised risk. The most compelling places to invest? Rothko EM All Cap and Rothko EM Small Cap. The investment case for Rothko is crystal clear.

2. EM Small Cap Flashing “Buy”

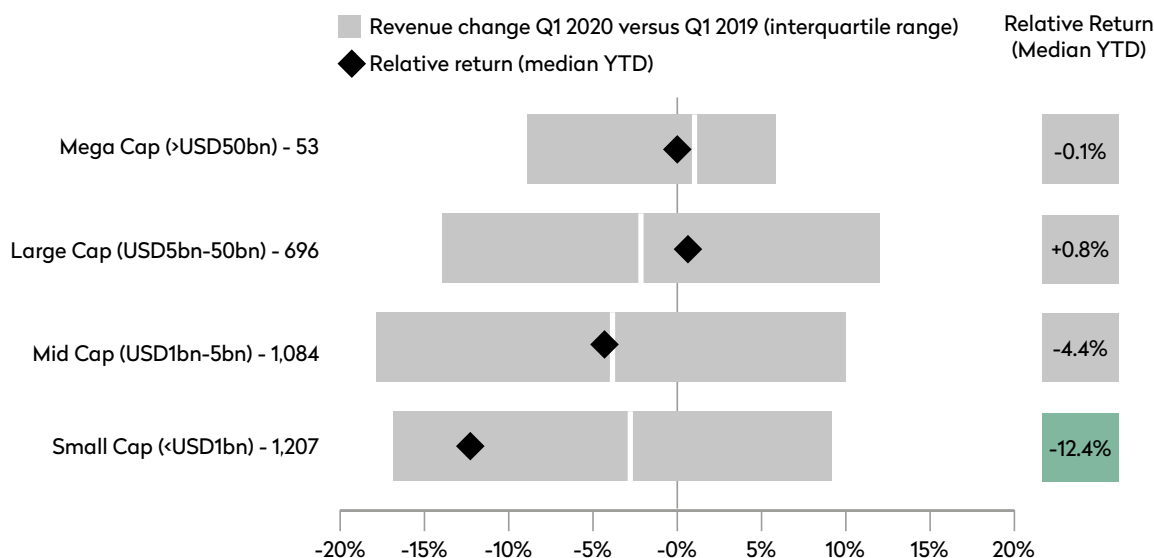
The unprecedented level of central bank intervention in response to the COVID-19 crisis has created a wall of money, which has been a game changer for financial markets in this crisis (please refer to our recent post). However well-intentioned this unprecedented stimulus has been, it has resulted in severe market dislocations. None more so than the valuations we see in EM Small Cap equities. Two examples of this are, firstly, the disconnect across the EM cap spectrum between fundamentals and pricing and, secondly, affirmations of mispricing from credit markets.

Dislocations across the cap spectrum

While reported median revenues this year are comparable across the cap spectrum, the price discounts for EM Small Caps have been, we believe, disproportionate (see Exhibit 2). Indeed, EM Small Cap saw a similar range of reported revenues over Q1 (and are seeing comparable ranges of forward earnings) as mid and large caps in EM. However, the market has delivered a double digit price discount for EM Small Caps. A fantastic opportunity in our view.

Exhibit 2: EM Small Cap Dislocation as at June 30, 2020

Reported Revenue Change and Median Relative Return



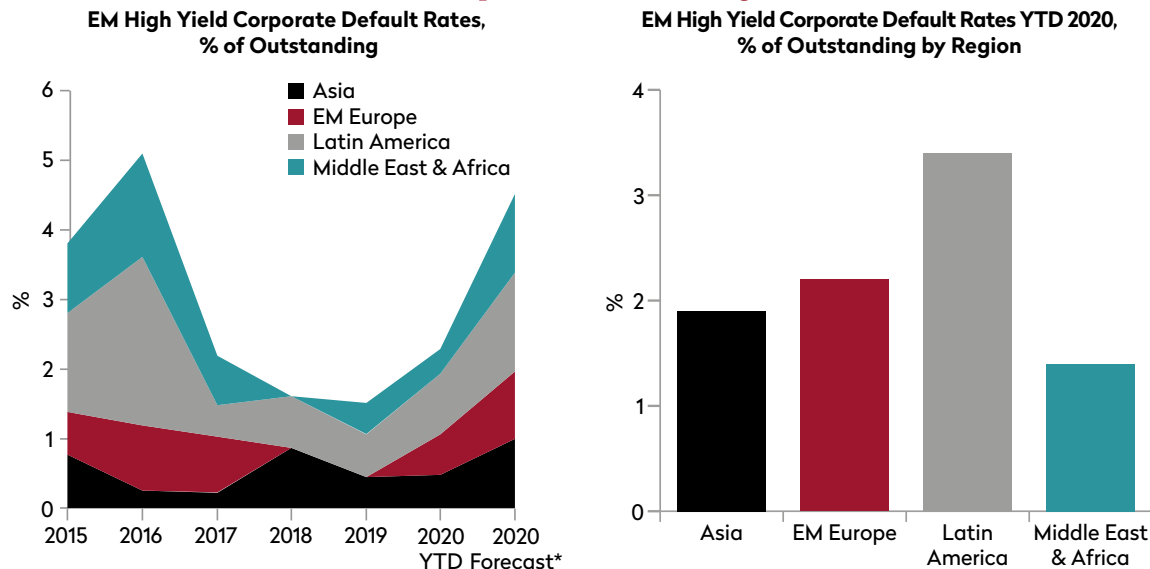
All numbers stated are in US Dollar terms. The stocks shown are in either the MSCI EM Index or the MSCI EM Small Cap Index. The relative year to date (YTD) return numbers are the median relative to the MSCI EM Index (gross). Revenue change is calculated as the percentage change in US Dollar revenue between Q1 2019 and Q1 2020.

Sources: MSCI, FactSet and Rothko Investment Strategies.

Credit risk priced in

In the throes of a global revenue shock, allocators now more than ever, need to be assured their EM equity managers are capable of trusting the companies in which they invest. “Trust” is not only synonymous with “credit”; the Latin word “credit” literally means “trust”. Few equity managers explicitly consider credit analysis in their investment process, and we think this is complacent. Rothko was originally formed as a melding of decades of fundamental equity investing expertise with decades of systematic credit analysis expertise, which now puts us in a uniquely advantageous position in a world where trust matters more than ever.

Exhibit 3: EM Corporate Defaults: Rising But Focused



*We have taken JP Morgan's forecast here as an indication of the consensus.
Sources: JP Morgan, Rothko Investment Strategies.

Forward earnings yield of EM Small Caps now more than +10.5%

EM corporates have so far registered a relatively low, 2.3% default rate this year, worst in Latin America at 3.5% so far. In contrast, Asian issuers have seen only a 1.9% default rate in this period, compared to the region’s highs of 3.1% in 2015 (see Exhibit 3). Defaults will certainly rise across corporate sectors and consensus expects these defaults to be focused in smaller issuers with a tilt to the commodities and energy-driven markets of LatAM and the Middle East and Africa. This is no surprise, and it is why Rothko prioritises resilience in our stock selection approach, blending the need for a good credit profile with that of evidential economic moats. We believe this is the only way to invest in EM Small Cap.

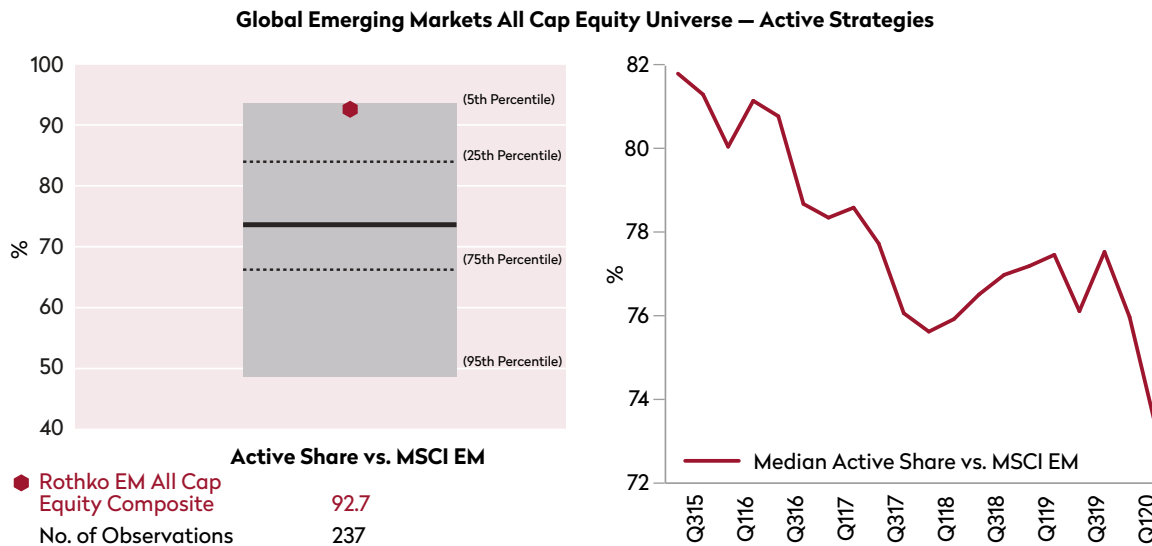
We note that the forward earnings yield of EM Small Caps is now more than +10.5%, making EM Small Caps look significantly undervalued from the perspective of credit risk also. (EM HY corporate bonds currently trade at around 660bps over Treasuries (JP Morgan CEMBI Broad HY Index)). Default expectations support the view that a secondary banking crisis in the major EM markets, particularly those in East Asia, is not yet on the cards, but we continue to monitor closely. All in all, we believe the signals from EM credit markets can be read as an affirmation of the value there is in selected EM Small Cap equities.

3. False Monikers and the Risk of Missing Out

EM Small Cap represents a fabulous opportunity in our view, but as allocators appreciate, it is not straightforward to gain access to a true active strategy with genuine exposure to an “all cap” alpha source. In fact, over the 5-year period to the end of Q1 2020, the median active share of strategies within the Emerging Markets equity universe has fallen from 82% to below 74% (see Exhibit 4). Mr Clive Gillmore, Mondrian Group CEO and veteran EM fund manager, describes this situation perfectly: “A strategy with high active share does not ensure high levels of outperformance but strategies with low levels of active share all but ensures lower levels of outperformance”. We are glad to say, all of Rothko’s strategies register an active share over 90%, making us truly active – a positive outlier in our nominally “active” peer groups.

Exhibit 4: Active Share of Emerging Markets Equity Strategies

Median Active Share of 'Active' emerging markets equity strategies has fallen dramatically as managers have become — semi-passive.



Data as at March 31, 2020

Sources: eVestment – Global EM All Cap Equity Universe ('active' strategies only), Rothko Investment Strategies, and MSCI.

“Low active share all but ensures low outperformance”

Allocators understand that EM strategies with “all cap” in the title tend to be anything but, while “active” means, on average, at least a 25% passive exposure (see Exhibit 4). Not just that, but larger fundamental strategies have the same 32% of exposures, on average, as their competitors (). We believe there has been a laissez-faire approach to using these monikers, something that seems to have become accepted while small cap has struggled. However, given the opportunity EM Small Cap now presents, this could cost allocators dear, should “all cap” alpha return with a vengeance, as we expect it to.

Highly Efficient, Truly “Active”, Definitely “All Cap”

The wall of central bank money continues to distort equities markets and continues to build opportunities, and we believe EM Small Cap remains among the best opportunities available. However, few “all cap” strategies truly invest across the cap spectrum, and “active” does not mean what it used to. It is important for allocators to keep this in mind, as accepting these false monikers at face value could well result in the very real pain of missing out.

Rothko’s strategy areas now represent the efficient frontier across international equities asset classes on a forward earning yield basis: Emerging Markets All Cap, Emerging Markets Small Cap, and All Countries World-Ex US. As illustrated our strategies show similar forward earnings yields to naive-Value but with significantly less risk.

Add to this that Rothko also has an active share of over 90%, for all of our strategies, and takes a truly active exposure to Small Cap, the case for our strategies could not be clearer.

Disclosure

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

Views should not be considered a recommendation to buy, hold or sell any security and should not be relied on as research or investment advice.

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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 (%)	Standard Deviation (%)	Number of Portfolios	Composite Dispersion	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
2020 (to Jun 30)	-16.83	-17.12	-9.78	17.56	18.26	2	N/A	10.5	0.02	45,793

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).