



Actively Benefiting from Emerging-Market Small Caps

PERSPECTIVE FROM TEMPLETON EMERGING MARKETS GROUP



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Executive Summary

We believe that the emerging-market (EM) small-cap space is an attractive proposition in the current investment climate. However, there are some common misconceptions regarding the asset class which, in our view, conceal key strengths that an active manager could benefit from. These include:

- **EM small cap is a niche asset class:** Contrary to this misconception, EM small caps constitute a vast investment universe with abundant liquidity. Meanwhile, individual stocks can account for a significant portion of a market or industry, with the largest market caps reaching up to US\$2 billion.
- **EM small caps are more volatile:** Despite this view, data demonstrate that volatility for EM small caps is not necessarily higher than for larger EM stocks.

In addition, the EM small-cap space has a number of *other* potential opportunities for active investors to take advantage of, in our opinion, including:

- **It is under-researched and under-owned:** Given the size of the investment universe, there is generally a limited research coverage of the asset class, often resulting in mispriced stocks. Active managers can then seek to benefit from direct analysis into inadequately covered companies.

- **Recapturing local growth:** Large-cap EM equities are heavily skewed to sectors such as information technology and financials that can be more closely impacted by global or country-level macroeconomic trends. However, EM small caps have performance drivers that are more likely to be determined by domestic demand, favorable demographics, local reform initiatives and innovative niche products. An active approach can seek out the attractive growth opportunities among small caps, while also having the flexibility to find prospects that have access to appealing global growth potential.

Overall, we believe that the above points present an attractive prospect for active managers as a multitude of mispriced securities, market inefficiencies and a paucity of research provide considerable opportunities for seeking alpha generation.

The Current Market Backdrop

So far in 2017, EM small-cap performance has been buoyant, with a strong advance across many countries and industries in the asset class. This year's gain has come as confidence in the market backdrop, economic environment and corporate earnings have improved across EMs, and despite challenges such as actual and potential US interest-rate moves, the uncertainty brought about by the new US administration and geopolitical issues globally.

Addressing Some Common Misconceptions Surrounding EM Small Caps

It Is Not a “Niche” Asset Class

Despite broad perceptions, in our view, EM small caps are far from being a niche investment. The asset class represents more than 20,000 companies with an aggregate market capitalization of over US\$5 trillion and daily turnover of over US\$40 billion, as Exhibit 1 demonstrates—liquidity within the EM small-cap market is comparable to that among EM large caps.¹ Accordingly, we think the sheer size of the EM small-cap investment universe is a key advantage for active managers, providing abundant opportunities to uncover mispriced companies.

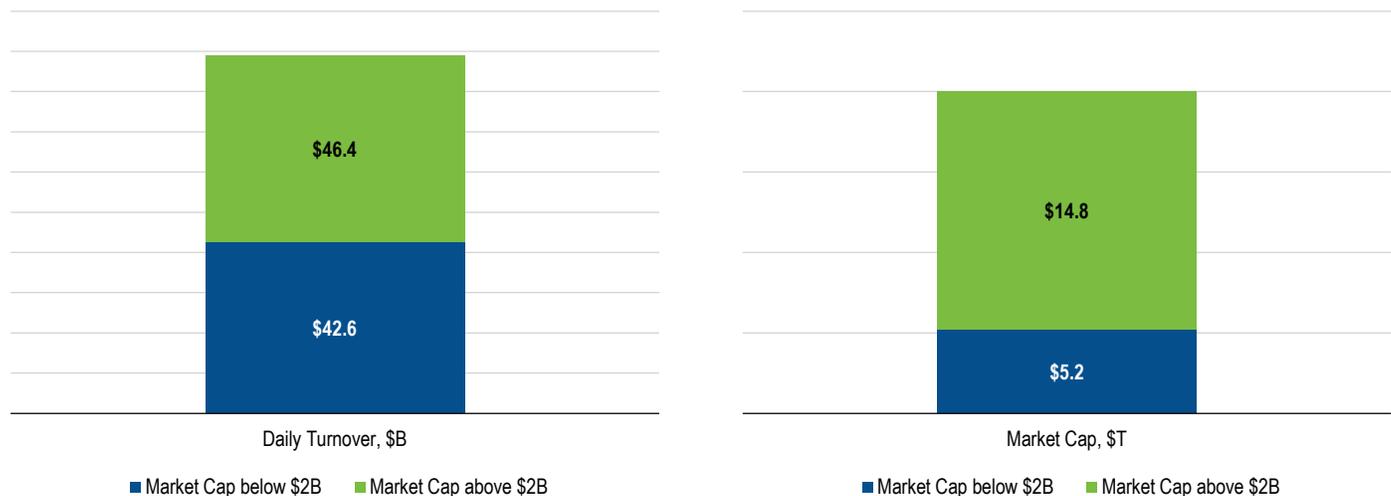
EM small caps are typically disproportionately owned by domestic retail investors, who often trade more frequently than foreign institutional investors because the former usually have a far

shorter investment horizon, boosting liquidity as a result. A good example of this is India—investors have a vast number of smaller companies to choose from, and the skew of ownership is toward local investors. In addition, disproportionate ownership by local investors can generate non-correlated outperformance that large-cap-focused investors would forego.

A key difference between developed-market small caps and EM small caps is that EM small caps in many markets are often still significantly important locally; a market capitalization of close to US\$2 billion could represent a leading company in a certain country, index or sector; perhaps a well-established business with a long and successful track record. Many of these companies are family owned or controlled, and many are companies with stable profiles when compared with developed-market small caps.

Exhibit 1: EM Small Caps Disproportionately Represented in Daily Trading Activity

As of June 30, 2017

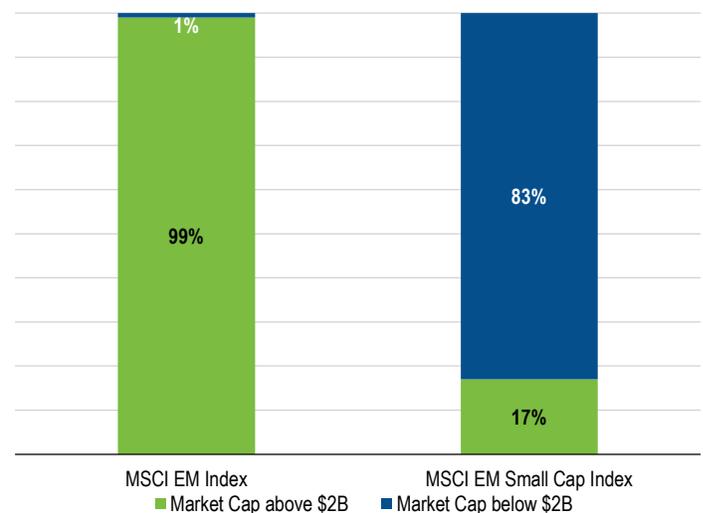


Source: Bloomberg, MSCI. For illustrative and discussion purposes only. Investment universe consists of all listed emerging-markets stocks, as defined by MSCI.

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Exhibit 2: EM Small Caps Underrepresented within EM Indexes

As of June 30, 2017



Source: FactSet. For illustrative and discussion purposes only.

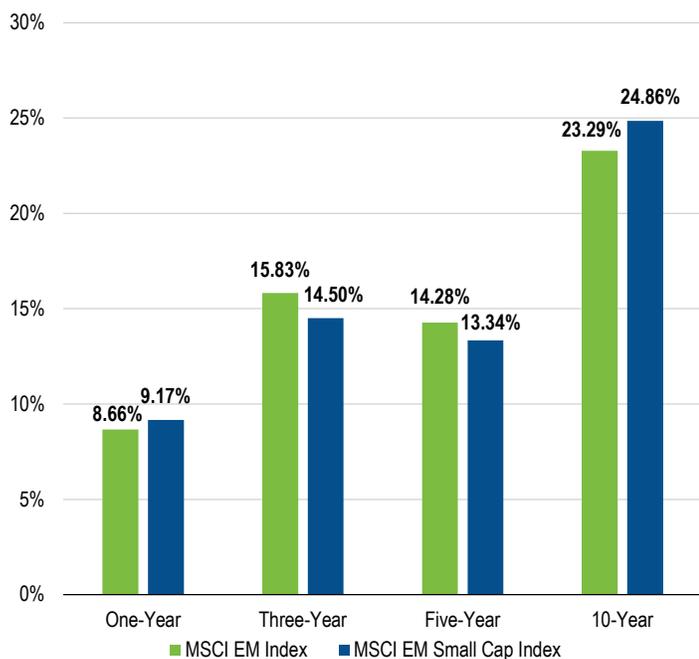
It Is Not Necessarily a More Volatile Investment

Another key misconception surrounding investment in EM small caps is that the volatility of these assets is higher than that of their larger-cap counterparts. Like all investments, EM small caps have real and perceived risks attached; some of these risks are those associated with the EM equity universe overall, such as increased volatility relative to developed markets. Other risks may be specifically associated with the EM small-cap asset class, including the perception that EM small caps are more volatile than larger-cap EM stocks. However, an analysis of standard deviations illustrates that this assumption does not hold.

Although individual stocks can indeed be very volatile, the pairwise correlations of different EM small-cap companies are lower, we believe in part due to the expansiveness and diversity

Exhibit 3: Volatility of EM Small Caps Compared to Larger-Cap EM Stocks

As of June 30, 2017

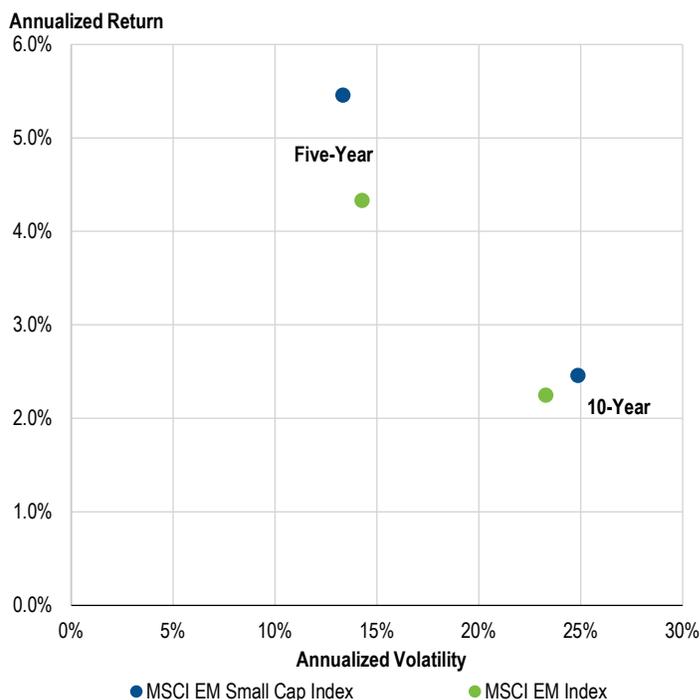


Source: Morningstar. EM small caps represented by the MSCI Emerging Markets Small Cap Index. Emerging markets represented by the MSCI Emerging Markets Index. Volatility measured by standard deviation over the noted time periods. **Past performance does not guarantee future results.**

of businesses within this investment space—a Korean television and online shopping stock, such as GS Home Shopping, is not impacted by the same factors as an Indian cement name, such as J.K. Cement, for example. This can help reduce risk at the asset-class level. This is demonstrated in Exhibit 3: Despite spiking during the 2008 crisis and subsequently rebounding, since then, the standard deviation of returns has been broadly comparable to that of the larger-cap index. What may be more important for investors is if the potential returns of the EM small-cap class compensate for the corresponding level of risk. Exhibit 4 highlights that over a five-year period EM small caps demonstrate lower volatility for higher returns when compared to EM large-cap stocks.

Exhibit 4: Superior Returns, Lower Risk of EM Small Caps and Emerging Markets

Five- and 10-Year Risk/Return Trade Off
As of June 30, 2017



Source: Morningstar. For illustrative purposes only. Volatility measured by standard deviation over the noted time periods. **Past performance does not guarantee future results.**

Other Opportunities for Active Investors

Overlooked and Under-Researched

Not only are EM small caps largely overlooked by investment managers, they are also notably under-researched by the sell side. This reflects not only the vast number of companies to cover, but also the relative lack of information available. Unsurprisingly, as shown in Exhibit 5, the result is that the average number of stock research recommendations for EM small caps is much lower than for larger-cap stocks. Also, many small-cap stocks have little or no research coverage. For a large number of EM small-cap stocks outside of the index, research availability is even more limited. This can give a critical advantage to an active manager that can directly research such companies as the opportunity of finding a relatively unknown off-index EM small-cap stock being mispriced is far greater than for a large company with many analysts producing research recommendations on it.

Recapturing Access to Local Exposure to Complement Existing EM Portfolios

Reflecting on the general long-term success of emerging markets, as global economies and as an equity asset class, most of these countries have become ever more integrated into the world economy. Consequently, their largest and most successful

companies have often expanded beyond domestic markets to export and invest globally. Accordingly, the share prices of many of these stocks are no longer primarily driven by domestic factors. Examples of such companies can include electronics, auto-industry or consumer-related names that derive a substantial portion of their revenues from developed economies rather than those in which they are based.

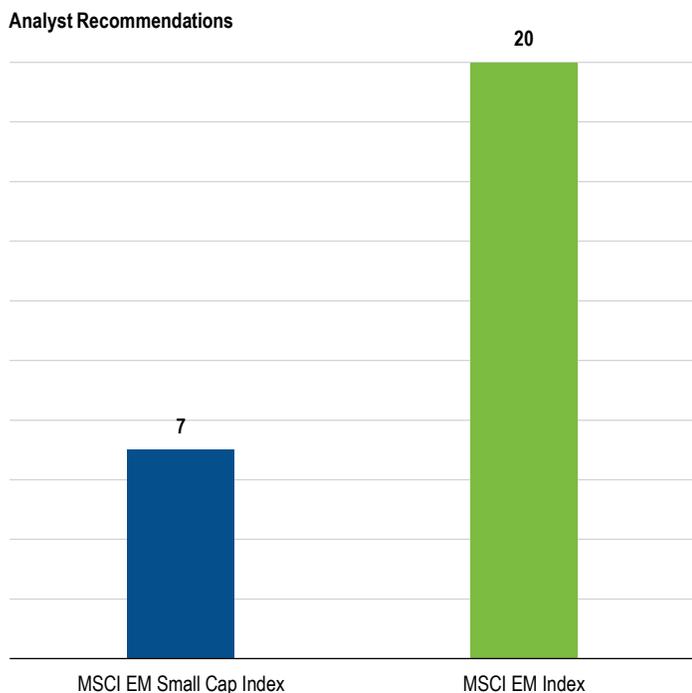
By contrast, EM small caps generally offer the very exposures that enticed investors to emerging markets in the first place, with domestic demand, favorable demographics, local reform initiatives and innovative niche products often being the primary determinants of growth.

Consequently, the sectors to which EM small-cap investors are exposed differ notably from those of larger-cap stocks, as Exhibit 6 shows. The MSCI Emerging Markets Index is disproportionately dominated by exposures in information technology and financials. These sectors are typically more closely impacted by global or country-level macroeconomic trends. In addition, state-owned enterprises are often more prevalent among larger-cap stocks, and while we find many such state-owned companies to be well managed, the interests of the ultimate owners are not always entirely aligned with those of minority investors.

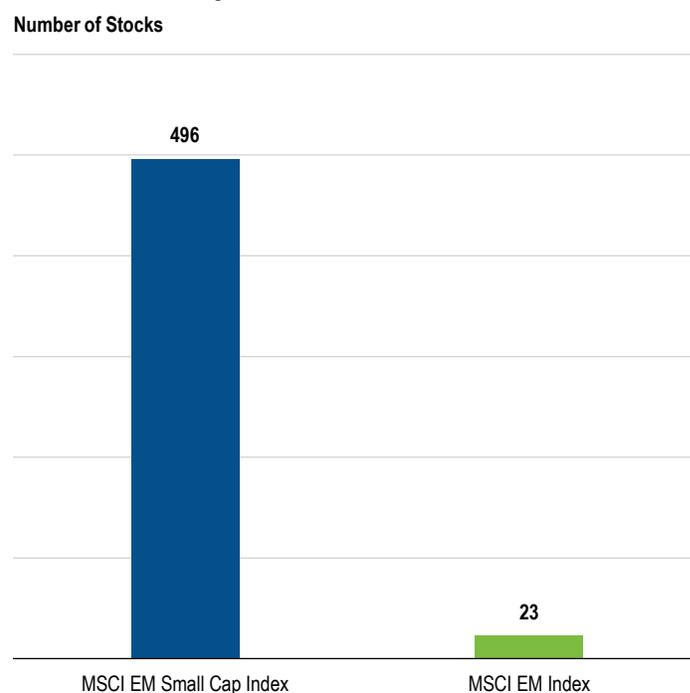
Exhibit 5: EM Small Caps Lack Analyst Coverage Relative to the Broader Emerging-Market Universe

As of June 30, 2017

Average Sell-Side Analyst Recommendations per Index Stock



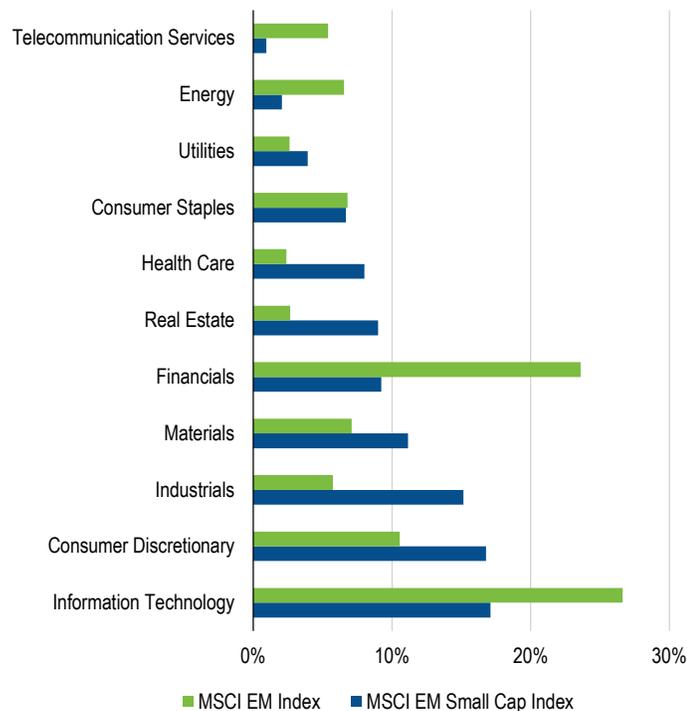
Index Stocks with Single or No Sell-Side Recommendations



Source: Bloomberg. EM small caps represented by the MSCI EM Small Cap Index. Emerging markets represented by the MSCI Emerging Markets Index. For illustrative and discussion purposes only. Negligible research coverage is defined as stocks having one or no research recommendations.

Exhibit 6: Side-by-Side Sector Comparison of Small- and Large-Cap EM Indexes

As of June 30, 2017



Source: FactSet. For illustrative and discussion purposes only.

In contrast, EM small-cap exposures are concentrated in higher-growth sectors, such as consumer discretionary and health care. Often these companies are more locally focused and many are relatively dominant players in smaller industries. The most successful EM small caps will leverage such local strength to expand internationally, supporting their transition into mid- or even large-cap companies over time. Even within a given sector economic exposures can differ substantially. For example, in the materials sector, mining companies by their nature are generally large-cap names and are impacted significantly by factors external to their home country, such as global commodity prices. EM small-cap materials companies likely include businesses such as cement producers, with greater exposure to local economic development and demand dynamics. Accordingly, diversifying into EM small caps can provide exposures that may complement an existing larger-cap-oriented EM allocation.

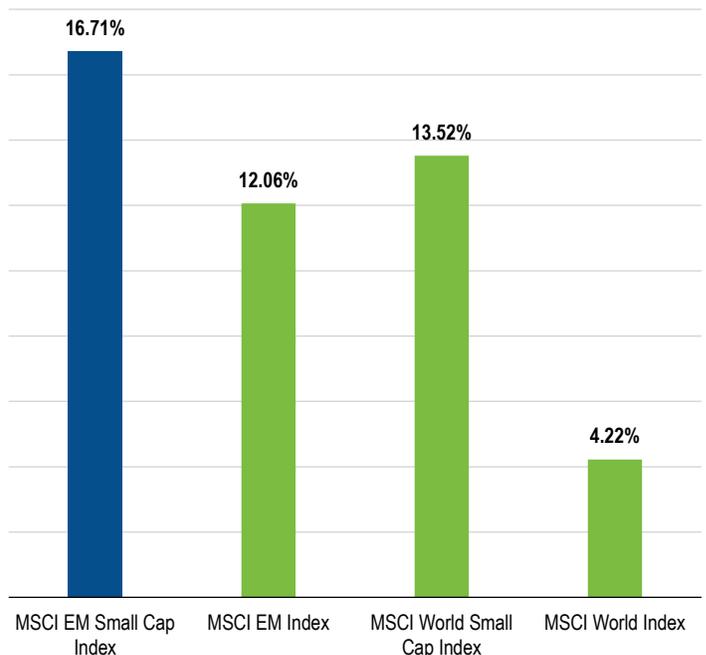
Finding Growth in a Low-Growth World

Emerging markets represent a possible bright spot in a sometimes uncertain world economic landscape. Although global growth rates have consistently disappointed since the 2008 financial crisis, in April 2017 the International Monetary Fund projected an expansion in global gross domestic product (GDP)

Exhibit 7: Ratio of Historical Three-Year Sales Growth of EM Small Caps Relative to EM Universe (Based on Performances of Index Constituent Companies)

As of June 30, 2017

Three-Year Annualized Historical Sales Growth



Source: FactSet. EM small caps represented by the MSCI EM Small Cap Index. Emerging markets represented by the MSCI Emerging Markets Index. For illustrative and discussion purposes only. **Past performance does not guarantee future results.**

growth from the 2016 level, to 3.5% in 2017. For advanced economies, the GDP growth expectation for 2017 is at 2%. However, as has consistently been the case, the expected growth rate for EMs together with other developing markets sits solidly above the global rate, at 4.5%.² In the eight years prior to 2008, EMs contributed 70% of the increase in world economic growth annually, and despite some moderation since then, aggregate EM GDP growth rates remain considerably higher than those in developed markets.³ In such a low-growth world, investing in EM small caps may provide exposure to many of the fastest-growing companies in the fastest-growing countries globally.

Exhibit 7 illustrates the higher sales growth of EM small caps compared to their larger-cap counterparts. It is also worth reiterating that this topline growth is typically organic and derived from local market dynamics, rather than being driven by global macroeconomic factors. In addition to organic growth, EM small caps may also see share-price appreciation from being added to an index (thus attracting passive investor flows, and with increased sell-side research attention likely active fund flows also) as well as being potential merger-and-acquisition targets—these are growth drivers that are, to a great extent, independent of macroeconomic considerations.

The Role of Active Management

How Else Can the Active Manager Add Value?

Minimizing Artificial Turnover

Since the MSCI EM Small Cap Index consists of a large number of stocks that can often have significant changes to their absolute and relative market capitalization from year-to-year, the semi-annual rebalance of the index can introduce high turnover in both names and weightings, as shown by Exhibit 8, which indicates that a total of 501 stocks were added or removed from the index over the 12 months to June 2017. A passive investment strategy based on the MSCI EM Small Cap Index may expose an investor to a higher level of transaction costs due to this continual index rebalancing, while active management that is not constrained by the composition of the index may minimize this artificial turnover and focus on the long-term potential of a given portfolio of investments.

Different from the Benchmark

As we saw in Exhibit 6, the small-cap benchmark has its own distinct composition, with skews toward the consumer discretionary, information technology and industrials sectors. Active managers do not have to follow this skew, if they feel the best stock ideas to add value lie elsewhere, or that these exposures are not appropriate for the current investment climate. Active managers can also aim to diversify better, moving exposures as appropriate, rather than being bound by the index. Another argument for active management is that many interesting small-cap names don't make it into the larger index, or don't have weights proportionate to their potential, and a non-index small-cap strategy can access these stocks.

Uncovering Success

Perhaps what is most important to recognize is that there are numerous EM small-cap companies that will likely remain small, whether due to corporate governance issues, poor quality of management, lack of market growth or other factors. The role of an active manager is to seek to determine which EM small-cap companies will succeed over the long term, with a view to reducing downside risk and thus enhancing risk-adjusted returns. With such a vast number of under-researched and under-owned companies in which to invest, a focus on bottom-up fundamentals can result in the construction of portfolios with highly attractive quality metrics at valuations lower than the EM small-cap index.

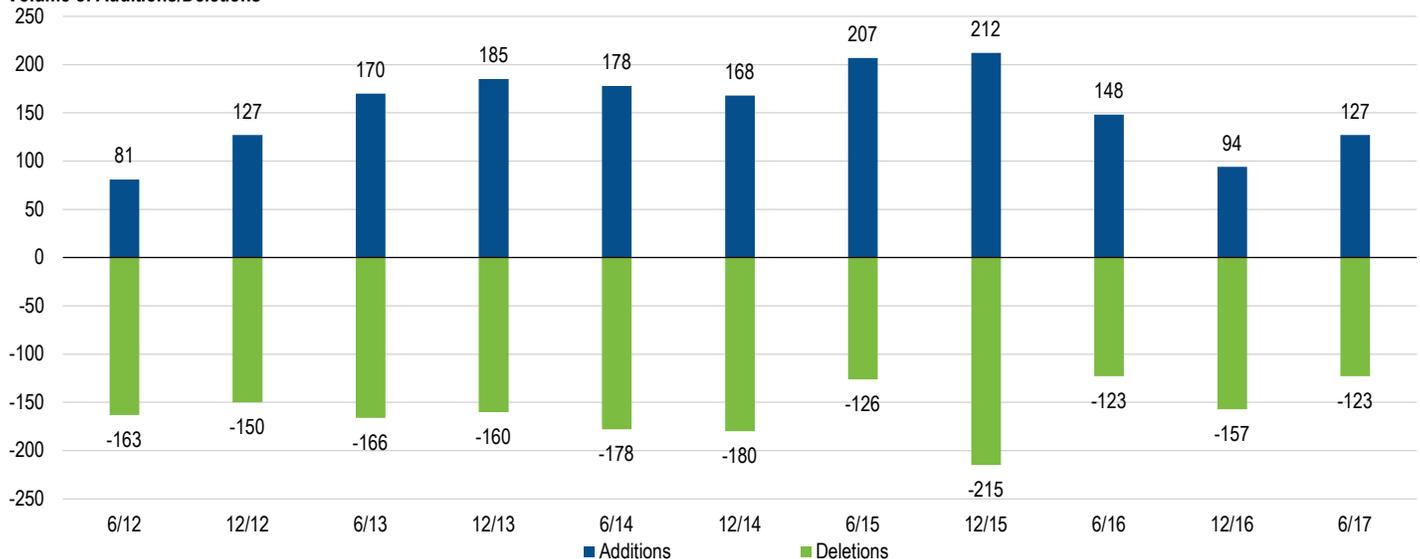
Our Active Focus

At Templeton Emerging Markets Group, we believe that the EM small-cap space is fertile ground for active managers who can focus on risk management and long-term growth drivers for the asset class. Our EM small-cap research is driven by an extensive on-the-ground team of over 50 analysts in 20 offices globally, which allows us to have regular face-to-face meetings with prospective investments and our investee companies. We also have strong research efforts, with a focus on corporate governance and risk management, and the aim of delivering on the structural reasons for EM small-cap investing—finding companies best positioned to benefit from the demographics and rising wealth of EM consumers, with sustainable and defensible business models. Overall, with our bottom-up, high-conviction, long-term investment approach we look to invest in companies with good management teams, where we feel conviction that they can make the right strategic choices. Price is crucial to our approach, with a value orientation driving our philosophy.

Exhibit 8: Turnover within the MSCI EM Small Cap Index (Six-Month Periods)

As of June 30, 2017

Volume of Additions/Deletions



Source: Bloomberg. For illustrative and discussion purposes only.

WHAT ARE THE RISKS?

All investments involve risks, including possible loss of principal. Special risks are associated with foreign investing, including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Because these frameworks are typically even less developed in frontier markets, as well as various factors including the increased potential for extreme price volatility, illiquidity, trade barriers and exchange controls, the risks associated with emerging markets are magnified in frontier markets. To the extent a portfolio focuses on particular countries, regions, industries, sectors or types of investment from time to time, it may be subject to greater risks of adverse developments in such areas of focus than a portfolio that invests in a wider variety of countries, regions, industries, sectors or investments. Investing in smaller company securities that may have limited liquidity involves additional risks, such as relatively small revenues, limited product lines and small market share.

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1. Source: Bloomberg, as of 6/30/17.

2. Source: IMF, World Economic Outlook, April 2017.

3. Source: IMF, World Economic Outlook, April 2017.

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