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Actively seeking opportunities in emerging markets

Identifying companies that will benefit from an expanding middle class around the world may take more than index-based investing

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Despite recent news highlighting the threat of new trade wars and other potential instability around the world, the secular trends in emerging markets remain promising for long-term investors.

Advisers seeking both diversification and growth can look beyond the headlines to focus on long-term trends, including the significant rise of consumer and business income in emerging-market countries and the development of innovative homegrown industries.

Economic development has shifted billions of people to the middle class, and the demographic data is compelling. Over the next seven years, the consuming class in EM countries will swell to 4.2 billion, with consumption expected to reach \$30 trillion, nearly half of the global total, according to research from McKinsey & Co.

ACTIVELY SEEKING OPPORTUNITY

To take part in equity growth in emerging markets, should investors simply rely on passive funds? Buying funds that track indexes and riding them upward may have worked

for domestic equities for extended periods during the U.S. bull market, but this approach may not translate when it comes to investing in today's emerging markets.

We believe that key EM indexes, such as the MSCI Emerging Markets Index, are overweight companies in "backward-looking," export-oriented industries such as the commodity and natural resource sectors. But the exciting growth in emerging market countries is inward-looking — disruptive companies that are addressing the buying power of the growing middle class.

That said, emerging economies are no different than developed economies — finding strong companies requires fundamental research and careful selection. As populations across Asia, Latin America and Africa gain greater discretionary income, they are seeking everything from e-commerce services to consumer products, health care and banking services.

While funds that track an index may seek to reflect the vast range of political, regulatory, monetary and investment environments across

EM countries, it's important to realize that companies and countries across the region are far from homogenous. Choosing promising companies should be based not only on company fundamentals, but also on the climate and markets in which companies are operating — and to which they are exporting. Understanding the complex global dynamics may influence part of the stock selection process.

CONSUMER TRENDS AND INNOVATION DRIVERS

Advisers serving clients with long-term growth objectives and the ability to withstand some volatility can find convincing data that point to promising trends in emerging markets. Just 12 years from now, the number of people in the world who are defined as middle class will likely double, according to the Organization for Economic Cooperation and Development. The underlying demographics support the idea that consumer spending and business development are on the rise: 90% of the global population under 30 years old currently

resides in EM countries. In India, 45% of the population is under 20.

With this in mind, innovation and disruption are positioned to create new growth industries and allow a select few businesses to potentially leapfrog their developed market peers, or thrive because of local conditions.

A population of innovators and disruptors is beginning to outpace the U.S. in the fields of science, technology and engineering. In 2016, there were more patents filed in EM countries than in developing market countries for the first time ever, according to the World Intellectual Property Organization. That same year, according to the World Economic Forum, China graduated 10 times as many science, technology, engineering and mathematics majors as the U.S., with India graduating five times as many.

The Massachusetts Institute of

Technology, for years considered the world's best engineering school, was displaced in 2015 by Tsinghua University, a research university in Beijing. MIT has since been bumped to the No. 3 spot by a university in Singapore, according to a ranking compiled by U.S. News.

The U.S. lost its spot among the top 10 in the 2018 Bloomberg Innovation Index for the first time since the gauge's inception six years ago. South Korea and Sweden held onto their No. 1 and No. 2 rankings, while the U.S. dropped from No. 9 to No. 11, in part because of its waning share of new science and engineering graduates in the labor force.

Meanwhile, the mobile wallet was first launched in the Philippines, then spread to other Asian EM countries with deep penetration rates. But it still hasn't taken off in the U.S.

LEVERAGING CHANGE

These shifting dynamics represent how emerging markets are seeing meaningful change. **We believe a manager best positioned to capitalize on these trends would be an active one that embraces deep fundamental research through an analyst team that can spot companies with sustainable growth, leadership in promising business spaces and significant competitive advantages.**

If the demographic and consumer trends are as clear as they seem, EM businesses have the potential to become the next generation of structural beneficiaries that will ultimately create value for shareholders.

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