

Finding Needles in the Emerging Markets Haystack



When you consider the sheer magnitude of investable equities to choose from in the world's emerging markets, you realize that finding one that looks attractive enough to warrant investing your faith and assets in is as formidable a task as finding a needle in a haystack.

Fortunately, researching investment opportunities is a lot more interesting than digging for needles in haystacks. I'm a firm believer in the value of first-hand experience, which is why I spend some 250+ days a year circling the globe to uncover companies that meet our quality criteria. Furthermore, I am always looking to buy shares at what are deemed to be a reasonable price. But I do have lots of help in this daunting endeavor—a team of 53 Templeton Emerging Markets investment professionals spread across 18 offices around the world, giving us a strong on-the-ground presence in the emerging markets.

When we first invested in emerging markets in 1987, there were only a handful of places we could invest in, and a limited number of companies. Today, 25 years later, we can invest in more than 60 countries in the emerging markets universe and have tens of thousands of companies to consider. So, where and how do we decide to invest?

It Begins with Research

No matter where we are looking to invest, the first step is research—and we do a lot of it. We have to confirm foreign exchange is available and look for a good global custodian.

Our research starts with a bottom-up approach, analyzing each individual stock. Who owns and controls the company, how does it operate and in what markets? The balance sheets have to be audited. We like to see statements going back five years so we can analyze them and make our projections five

years out in time. Here are a few factors we consider when analyzing accounts:

- ✔ Trends in profit margins.
- ✔ Ratio analyses, such as price-earnings ratios, dividend yields, and debt-to-equity.
- ✔ In companies involved in manufacturing and sales, we monitor inventory, accounts receivable and order backlog trends. These can be strong indicators of potential problems, and we find they tend to be more closely aligned with potential stock returns than reported earnings.

We visit as many of the companies we invest in as we can. We try to get to know not only the management, but also the employees. We do a lot of factory visits too, so we can see things going on outside the boardrooms and gain a better understanding of the production processes. I also like to talk to people living and working in a country to get a sense of their lives and their views of the economy. Often, local people can offer you insights about a company—or a country—that you won't find in a glossy brochure.

The Importance of Corporate Governance

Corporate governance is a very, very important issue for us, because we want to assure the interests of shareholders are being addressed. So one of the first things we look for is a strong culture and ethical conduct; we won't invest if we perceive there to be any impropriety or hints of corruption. We conduct analysis of ownership structures, the management team's track record, the company's corporate governance history and its commitment to creating shareholder value. We look for managers who know the business well and have experience in a given field. They should be properly motivated through incentives such as stock options on shares of the company they manage. We also pay attention to management's ability to cope with a rapidly changing business environment.

We've seen examples of this during market crisis periods. For example, we were investing in Thailand during the mid-to-late 1990s, when the market suffered a heavy blow and investor confidence was bleak. We could see how important the strength of management of a company was and what steps they took to survive the crisis—or didn't. It also offered us the opportunity to invest in what we saw as companies with good prospects, but that we felt were undervalued by the marketplace.

Of course, there are always risks, and not all companies can survive crisis periods. We try our best to see if the risks a company takes are rational and have the potential to be properly rewarded, the same type of risk-management approach we take at Franklin Templeton. Vetting processes aren't perfect. But, with experience, you try not to repeat the same mistakes twice.

One last point that's important to mention here is dividends, which we believe are typically a sign of good corporate governance. Dividends are an important consideration when we evaluate an investment.

Determining Value

Successful investing is not only about picking the right stocks, but also finding values others may not recognize. We think the best way to determine if a stock is a value really boils down to growth. During market downturns many stocks can be cheap, but if there is no future growth potential, than that stock could be considered a value trap. If a company is inexpensive and growing (and our earnings projections for it look good), then there can be a good case to invest.

When the current market isn't recognizing this potential and we're able to buy stocks at a discount to what we think they'll be worth five years out, then that's where we see value. During a severe market downturn, you've got to be willing to go into the market, then wait. The global market downturn in 2008-2009 is a good example of this. Patience and a willingness to go against the crowd mentality is a very difficult thing for most investors to do, but we believe it is critical as a long-term investor.

Liquidity

One issue I'm often asked about is liquidity, which is particularly important when investing in frontier markets, which are the less developed tier of emerging markets. In frontier markets, you will find in some cases the liquidity is very low and you may have to wait a long time to buy the stock and gradually build a position.

The disadvantage is that when you want to get out, you may not be able to do so. The advantage is that if it's a good company and other buyers want it, they often are willing to pay you a premium. So the issue of liquidity is a double-edged sword, so to speak. It can be beneficial in some cases, but in others, it's not.

The Importance of Understanding People

Obviously the world is a big place with a big variety of countries, cultures, languages and industries. But no matter where they live, people are still people, not as dissimilar as you might expect. Gaining an insight into the hopes and desires of the people who live and work in the countries we invest in, we think, is really the secret to global investing. By examining not only the statistics, but also the motivation of the management and owners of companies, we can then join with them in seeking to achieve their goals. It's true in China, it's true in India, it's true in Thailand and it's true in Turkey—or anywhere else on the map.