Quick takes

Investor Insights from UBS Asset Management

Shifting gears

New drivers of growth in emerging markets present potential opportunities for investors

In the short term, emerging markets tend to be vulnerable to a variety of event risks. At the moment, open questions such as China-US trade, elections in Indonesia, India and Thailand, or even the slightly farther flung Brexit could have uncertain impact depending on the direction they take.

That said, looking past those temporal concerns to the long term, there is a potential opportunity now. Valuations in emerging markets are currently cheap by historical standards. Some would say they are currently trading on average only about 10% above what could be considered crisis levels. But perhaps more importantly for long-term investors, emerging markets have also become the primary driver of growth in the world.
About two-thirds of the economic growth in the world over the next five years is expected to come from emerging markets, roughly split in half between China and from the rest of EM. Going forward more of global growth is expected to come from internal EM production and consumption, and trade between EM countries. That is an key development for EM equities.

Old definitions of globalization are past their prime, investors may want to think about new ways to participate in this emerging growth paradigm.

**The times they are a-changin’**
The globalization trend that has contributed to world growth in the past decades was rooted in trade. Manufacturing began to move to “Tiger” economies in the 1960s and 1970s, making trade an essential component of global growth, and in the 1990s the opening of China introduced a juggernaut of trade. But currently the emerging world is experiencing a tectonic shift: the ongoing transition from producing for overseas markets to producing for domestic markets.

Given the shift in growth dynamics, going forward, more production and consumption will come from and in EM countries. Emerging markets are expected to contribute 62% of global economic growth over the next five years, far exceeding the combined 25.8% expected contribution from the US and Euro area.¹

Why? Well, for one, the population of working age people in EM countries is expected to grow 0.81%, on average, per year between 2019 and 2050, while it is expected to decline 0.3% per year in developed markets.² This means that EM countries will produce more than 100% of the growth in the working age population. That demographic change is significant because it means that growth in the world’s consumer base will come from EM and support domestic demand growth.

If you look at emerging market companies it is easy to see how this is already manifesting itself. For instance, companies in the MSCI EM index now derive 71% of their revenues from either their home countries or from other EM countries, and a whopping 93% of revenue for companies in the MSCI China index comes from China.³

**Does it matter?**
While a large percentage of global growth is expected to now come from EM, many US investors have little or no exposure to these markets. Also, growth in EM has different drivers than for the typical growth companies in the US—think the FANGs (Facebook, Amazon, Netflix and Google)—so it is typically not correlated with the US.

When investors buy an EM portfolio they are buying companies that are primarily targeting their local, growing markets, and they are increasingly in expanding domestic demand-related sectors, like consumer and IT, which have taken market share in EM indices away from traditional EM sectors such energy, materials, industrials and telecom.

There are many growth stories emanating from the domestic demand trend in EM. One is simply the surge in research and development. The emerging markets are producing growing companies because firms in the region are ramping up R&D spending⁴ and becoming more innovative.

For instance, China has become the second biggest R&D spender in the world, second only to the US. Rather than manufacturing low tech products such as shoes or clothing and borrowing technology from the developed world, China is transitioning to higher tech products, as well as premium brands and services for the emerging middle class, and developing their own new technologies.

Additionally, as incomes and the number of better-off households rise in EM, consumers are trading up for better quality brands and premium goods. Producers of higher end consumer products, such as specialty beer and designer clothing, are benefitting from this growing demand. Also, in some EM countries the banking sector may offer interesting opportunities as they still have much lower levels of credit penetration than in more developed countries, and they are positioning to catch up.

All of these transitions produce winners and losers among companies, and a professional active manager, with the ability to understand the companies and dynamics at play, may have potential to identify companies with potential to succeed in this environment.

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¹ Source: IMF, Haver, UBS, June 2018. Projections to 2023
³ Source: UBS AM, Factset, March 2018
⁴ Source: OECD, WIPS, Morgan Stanley Research estimates, as of December 2018
Boots on the ground
Active managers with a sophisticated “boots on the ground” research capability, in particular, can add value in emerging market investing, as the profiles of countries, regions and industries are less transparent and more idiosyncratic. An investment manager with a deep, global research and portfolio management platform that has analysts in EM countries—interacting directly with company management and even key government officials and policymakers—can have an information advantage that can potentially make a difference in a growing, but complex, and sometimes opaque emerging marketplace.

There were headwinds for EM in 2018: the rise in the US dollar, higher US interest rates and a concurrent economic deceleration in China. However these factors appear to have abated somewhat or turned the corner. And, emerging markets are now in an easier interest rate environment, and there are some signs of green shoots of economic activity. So the environment in emerging markets may have become comparatively benign.

Investors looking to achieve their financial goals should have a long-term horizon. The emerging markets story is one that is expected to continue to play out over the next generation. For investors looking for diversification and growth, now might be a good time to consider broadening their investment horizon. Talk to your financial advisor about whether an allocation to emerging market equities might be something to consider.
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Asset allocation, diversification and rebalancing strategies do not ensure gains nor guarantee against loss.

Index definitions:
The MSCI Emerging Markets Index (net) is a market capitalization-weighted index composed of different emerging market countries in Europe, Latin America, and the Pacific Basin. Net total return indices reinvest dividends after the deduction of withholding taxes, using a tax rate applicable to non-resident institutional investors who do not benefit from double taxation treaties. The index is constructed and managed with a view to being fully investable from the perspective of international institutional investors. Investors should note that indices do not reflect the deduction of fees and expenses. The MSCI Emerging Markets Index (net)’s inception date is December 31, 1998.

Limited Regulatory Oversight
Since Alternative Investments are typically private investments, they do not face the same oversight and scrutiny from financial regulatory entities such as the Securities and Exchange Commission (“SEC”) and are not subject to the same regulatory requirements as regulated investment companies, (i.e., open-end or closed-end mutual funds) including requirements for such entities to provide certain periodic pricing and valuation information to investors. Hedge fund offering documents are not reviewed or approved by the SEC or any US state securities administrator or any other regulatory body. Also, managers may not be required by law or regulation to supply investors with their portfolio holdings, pricing, or valuation information.

Portfolio Concentration; Volatility
Many Alternative Investments may have a more concentrated or less diversified portfolio than an average mutual fund. While a more concentrated portfolio can have good results when a manager is correct, it can also cause a portfolio to have higher volatility.

Strategy Risk
Many Alternative Investments employ a single investment strategy. Thus, a Hedge Fund or even a fund of Alternative Investments may be subject to strategy risk, associated with the failure or deterioration of an entire strategy. Strategy specific losses can result from excessive concentration by multiple Hedge Fund managers in the same investment or broad events that adversely affect particular strategies.

Use of Leverage and Other Speculative Investment Practices
Since many Hedge Fund managers use leverage and speculative investment strategies such as options and short sales, investors should be aware of the potential risks. When used prudently and for the purpose of risk reduction, these instruments can add value to a portfolio. However, when leverage is used excessively and the market goes down, a portfolio can suffer tremendously. Also, managers can face additional risk when selling short. In theory, the loss associated with shorted stocks is infinite, because stocks can go up indefinitely. So, while selling short can add return and risk reduction to a portfolio, managers need to pay special attention to their short positions. In the same way, when options are used to hedge a portfolio (i.e., short calls and buy puts), the portfolio’s volatility can be reduced. However, when options are used to speculate (i.e., buy calls, short puts), a portfolio’s returns can suffer and the risk of the portfolio can increase.

Valuations
Further there have been a number of high profile instances where Hedge Fund managers have mispriced portfolios, either as an act of fraud or negligence.

Past Performance
Past performance is not necessarily indicative and is not a guarantee of a Hedge Fund’s future results or performance. Some Alternative Investments may have little or no operating history or performance and may use hypothetical or pro forma performance that may not reflect actual trading done by the manager or advisor and should be reviewed carefully. Investors should not place undue reliance on hypothetical or pro forma performance.

Limited Liquidity
Investors in Alternative Investments often have limited rights to redeem or transfer their investments. In addition, since Alternative Investments are not listed on any exchange, it is not expected that there will be a secondary market for them. Repurchases may be available, but only on a limited basis. A Hedge Fund’s manager may deny a request to transfer if it determines that the transfer may result in adverse legal or tax consequences for the Hedge Fund.

Investors in certain jurisdictions and in Alternative Investments generally may be subject to pass-through tax treatment on their investment. This may result in an investor incurring tax liabilities during a year in which the investor does not receive a distribution of any cash from the Fund. In addition, an investor may not receive any or only limited tax information from Hedge Fund and funds of Alternative Investments may not receive tax information from underlying managers in a sufficiently timely manner to enable an investor to file its return without requesting an extension of time to file. In certain jurisdictions a lack of tax information may result in an investor being taxed on a deemed basis at an adverse rate of tax.

Fees and Expenses
Most Alternative Investments charge both an asset-based management fee and a performance-based incentive fee or allocation. In addition, many Alternative Investments are more actively traded than a long-only mutual fund and thus have greater commission expenses for securities trading. As a result, the fees and expenses associated with Hedge Fund investing may exceed those of a long-only mutual fund.

Reliance on Fund Manager; Lack of Transparency
A Hedge Fund’s manager or adviser has total trading authority over the Hedge Fund. There is often a lack of transparency as to the Hedge Fund’s underlying investments. Because of this lack of transparency, an investor may be unable to monitor the specific investments made by the Hedge Fund or to know whether the investments are consistent with the Hedge Fund’s historic investment philosophy or risk levels. Due to the risks mentioned above, it is important to perform proper due diligence in evaluating and choosing Hedge Fund managers to place your money with. There have been occasions when Hedge Fund managers took on too much risk in their portfolio and lost a substantial amount of their investors’ money.

Interests of Alternative Investment Funds (the “Funds”) are sold only to qualified investors, and only by means of offering documents that include information about the risks, performance and expenses of the Funds, and which Clients are urged to read carefully before subscribing and retain. This communication is confidential, is intended solely for the information of the person to whom it has been delivered, and should not be reproduced or otherwise distributed, in whole or in part, to third parties. This is not an offer to sell any interests of any Fund, and is not a solicitation of an offer to purchase them. An investment in a Fund is speculative and involves...
significant risks. The Funds are not mutual funds and are not subject to the same regulatory requirements as mutual funds. The Funds’ performance may be volatile, and investors may lose all or a substantial amount of their investment in a Fund. The Funds may engage in leveraging and other speculative investment practices that may increase the risk of investment loss. Interests of the Funds typically will be illiquid and subject to restrictions on transfer. The Funds may not be required to provide periodic pricing or valuation information to investors. Fund investment programs generally involve complex tax strategies and there may be delays in distributing tax information to investors. The Funds are subject to high fees, including management fees and other fees and expenses, all of which will reduce profits. The Funds may fluctuate in value. An investment in the Funds is long-term, there is generally no secondary market for the interests of the Fund, and none is expected to develop. Interests in the Funds are not deposits or obligations of, or guaranteed or endorsed by, any bank or other insured depository institution, and are not federally insured by the Federal Deposit Insurance Corporation, the Federal Reserve Board, or any other governmental agency. Prospective investors should understand these risks and have the financial ability and willingness to accept them for an extended period of time before making an investment in a Fund. Investors should consider a Fund as a supplement to an overall investment program.

Foreign investing and emerging markets risks.
Investing internationally presents certain risks not associated with investing solely in the US such as currency fluctuation, political and economic change, social unrest, changes in government relations, differences in accounting and available legal remedies, and the lesser degree of accurate public information available. A decline in the value of foreign currencies relative to the US dollar will reduce the value of securities denominated in those currencies. Also, foreign securities are sometimes less liquid and harder to sell and to determine the value of than securities of US issuers. Each of these risks is more severe for securities of issuers in emerging markets countries.

US companies include any company organized outside of the United States, but which (a) is included in an index representative of the United States; (b) has its headquarters or principal location of operations in the United States; (c) whose primary listing is on a securities exchange or market in the United States; (d) issues securities that are guaranteed by the United States government, its agencies, political subdivisions or instrumentalities; (e) derives at least 50% of its revenues in the United States; or (f) has at least 50% of its assets in the United States.

The fund is permitted to invest in “F” shares (so called due to their ticker symbols, which end in “F”). F shares are ordinary shares of a foreign company’s common stock that trade in their home (local) market. F shares are quoted in US dollars by registered market makers who provide their quotes on over-the-counter (“OTC”) quote platforms. F shares provide access to the securities of certain foreign companies that do not have ADRs available.

There are certain risks associated with investing in F shares. The risks include, but are not limited to, the risks associated with foreign investing. F shares are not listed on US exchanges, but are subject to foreign local registration requirements. F shares trade over-the-counter via the “pink sheets” based on broker/dealers or market makers who offer quotes and, therefore, are not subject to the listing and reporting requirements of issuers listed on a US exchange. Further, as F shares access the same liquidity as the local (foreign) market, when local markets are closed, liquidity will be reduced and spreads may be wider. F shares are also subject to the risk that a market maker may decide to exit the market for a particular company’s F shares thereby reducing liquidity and widening the security’s spreads. F shares are not listed on US exchanges, but are subject to foreign local registration requirements. F shares trade over-the-counter via the “pink sheets” based on broker/dealers or market makers who offer quotes and, therefore, are not subject to the listing and reporting requirements of issuers listed on a US exchange. Further, as F shares access the same liquidity as the local (foreign) market, when local markets are closed, liquidity will be reduced and spreads may be wider. F shares are also subject to the risk that a market maker may decide to exit the market for a particular company’s F shares thereby reducing liquidity and widening the security’s spreads. F shares are not listed on US exchanges, but are subject to foreign local registration requirements. F shares trade over-the-counter via the “pink sheets” based on broker/dealers or market makers who offer quotes and, therefore, are not subject to the listing and reporting requirements of issuers listed on a US exchange. Further, as F shares access the same liquidity as the local (foreign) market, when local markets are closed, liquidity will be reduced and spreads may be wider. F shares are also subject to the risk that a market maker may decide to exit the market for a particular company’s F shares thereby reducing liquidity and widening the security’s spreads.

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