# Pyramis Global Advisors®

## Emerging Markets—The Intersection of Challenges and Opportunities

November 7, 2013

**Brian Drainville, CFA**
*Institutional Portfolio Manager*

For Institutional Use Only

Pyramis GLOBAL ADVISORS™ A Fidelity Investments Company

## Table of Contents



See "Important Information" for a discussion of additional information related to this presentation.

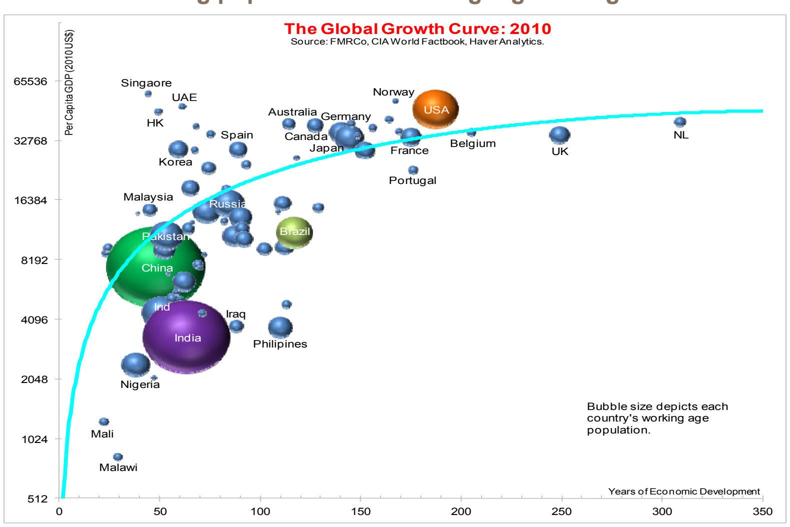

For Institutional Use Only
201112-10543

# Emerging Markets Opportunity

For Institutional Use Only

# Long Term Potential

## Countries with big populations are driving high GDP growth rates




Data source: FMR, Bloomberg, Haver Analytics, Factset, CQG. Annual data as of August 30, 2011.

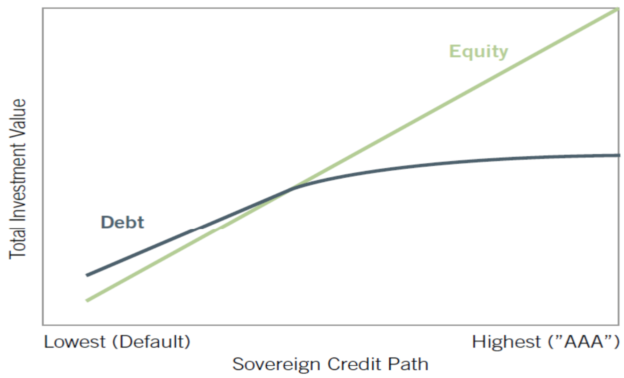
 For Institutional Use Only

# Long Term Potential

**We believe equity is a better way to capture EM wealth creation**

Improvement in sovereign credit quality is a key factor

CONCEPTUAL FRAMEWORK:
TOTAL INVESTMENT VALUE AS A FUNCTION OF
CHANGING UNDERLYING SOVEREIGN DEBT




Source: Journal of Portfolio Management (Kelly, Martins, Carlson), Spring 1997



For Institutional Use Only

201112-10543

# Challenges of Investing in Emerging Markets

| Volatility | Policy and Politics flux | Higher Cyclicality | No protection for minority rights |
|---|---|---|---|
| Over time, EM equities have volatility 30% above the S&P 500 | • Weaker political/economic institutions<br>• Opaque policy making<br>• Underdeveloped rule of law | • Export oriented, commodity heavy<br>• Monetary /fiscal policy making tend to amplify economic cycles | • Corporate Governance and disclosure standards are loose<br>• Legal protection for minority shareholders may not exist |

Source: FMR Analysis. Data as of 2012.
Index performance does not reflect the deduction of advisory fees, transaction charges and other expenses, which would reduce performance. Investing directly in an index is not possible.



For Institutional Use Only

# The Intersection of Opportunities and Challenges

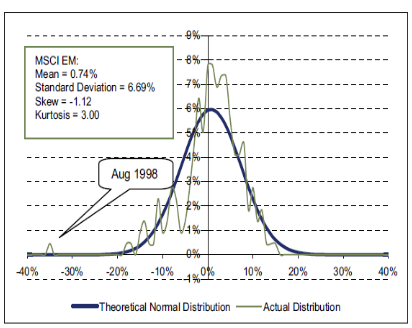
How to Approach Investing in Emerging Markets

For Institutional Use Only

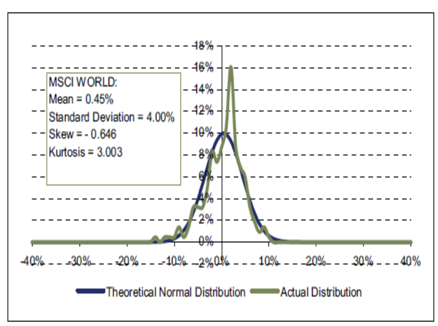
# Black Swans are more common in EM

**MSCI EM index has nearly twice negative skew than MSCI World**

**Returns Distribution: MSCI Emerging Markets Index**




**Returns Distribution: MSCI World Index**




Source: MSCI Standard Indices

Source: MSCI, Returns Distribution s shown for 1988-2007, pre-Global Financial Crisis period only

# Importance of Limiting Downside

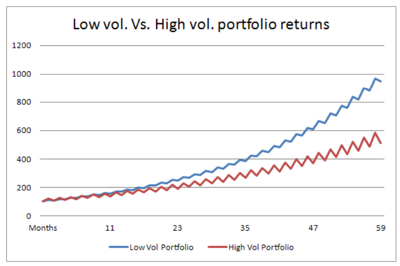
## Higher draw downs negatively impact compounded returns over long run

**Assume 2 portfolios:**

- Low Volatility Portfolio:
  - Alternating monthly returns of **10%** and **-2%**
  - Expected Returns = 10% X 0.5 + (-2%)X 0.5= **4%**

- High Volatility Portfolio:
  - Alternating monthly returns of **20%** and **-12%**
  - Expected returns = 20% X 0.5 + (-12%) X 0.5 = **4%**

**As the graph below shows, compounded return of the low volatility strategy is higher than for the high volatility strategy**



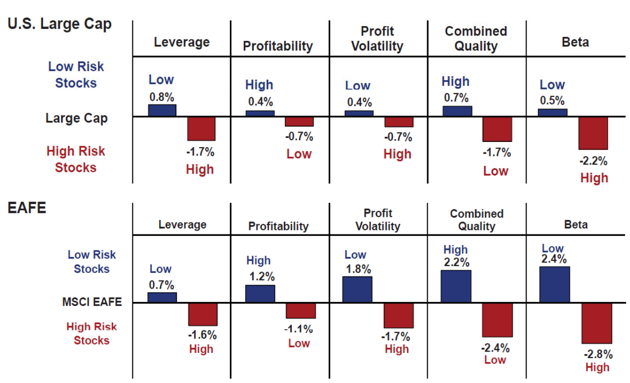

For illustrative purposes only. Not intended to represent an investment in any Pyramis product.



# Importance of Limiting Downside

## Strong Empirical Evidence from Developed Markets

**Safer Characteristics Tend to Outperform: The Relative Performance of Low-Risk Stocks vs. High-Risk Stocks**

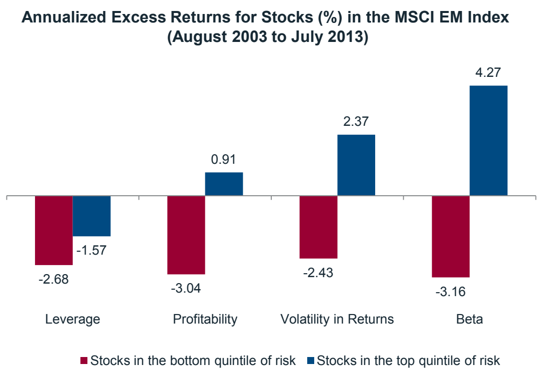



For the table above, U.S. Large Cap Stocks (the largest 1000 companies in the U.S.) and all companies within the EAFE index were sorted into approximate quartiles based on the factors above. The low and high bars represent the relative returns of those companies in the quartiles with the lowest and highest scores in each factor.

*Source: GMO GMO annualized data from 1/65 – 12/11 (U.S.) and 1/85 – 12/11 (EAFE)*

# Importance of Limiting Downside

## Similar Strong Empirical Evidence from Emerging Markets




- This evidence goes against the Capital Asset Pricing Model of Financial Theory (Higher Risk -> Higher Returns)
- So the question is why does this anomaly exist? The possible answer lies in Behavioural Finance

Source: Factset, Pyramis/FMR Analysis, July 2013; Leverage = Total Debt/EBITDA (ex-financials), Profitability = Return on Equity, Volatility in Returns = 5 year highest ROE less lowest, Beta based on 104 weeks of weekly returns



# Importance of Limiting Downside

## Explaining the 'low risk' anomaly

| Preference for Lotteries | Representativeness | Overconfidence | Compensation structure for PMs |
|---|---|---|---|
| Buying a volatile stock is like buying a lottery ticket: There is a small chance of its doubling or tripling in value in a short period and a much larger chance of its declining in value. | Popular press regularly highlights multi-bagger stocks in relatively speculative sectors such as Technology, Resources Exploration, while failing to mention a high rate of failures in these sectors. | People are usually overconfident about their abilities, especially when it comes to forecasting the future. For higher volatility stocks, potential pay off of getting your forecasts right is higher | Benchmark focus makes institutional managers less likely to exploit this low volatility anomaly |

Source: Benchmarks as Limits to Arbitrage: Understanding the Low-Volatility Anomaly, Financial Analysts Journal Vol. 67, No. 1, 2011

# Key Considerations in a Low Risk Investment Approach



## Limiting Portfolio Downside Risk

**Case for geographic diversification: Countries/regions have very distinct drivers**

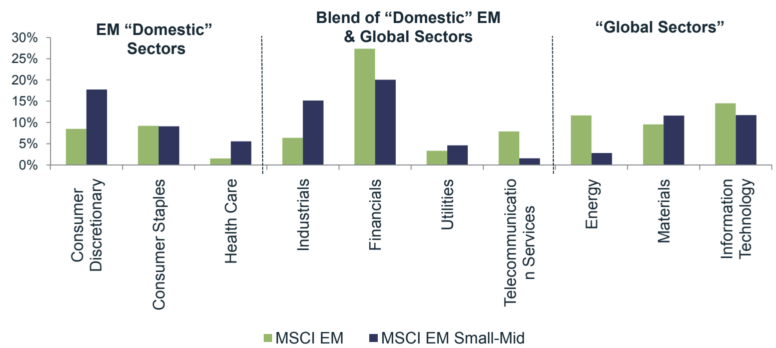

**Variations in Drivers Results in Changes in Leadership over Time**

- Malaysia and Mexico were the biggest EM countries by market cap in 1992
- Korea and Brazil are the biggest in 2013

# Limiting Portfolio Downside Risk

## Domestic sectors may offer more steady returns

- Approx. 35% of MSCI EM benchmark (26% for EM SMID) consists of export oriented sectors such as Information Technology and Resources
- This combined with relatively inefficient coverage of stocks with in Emerging Markets, offers the potential to create low risk investment portfolios exposed to more secular steadily growing stocks.

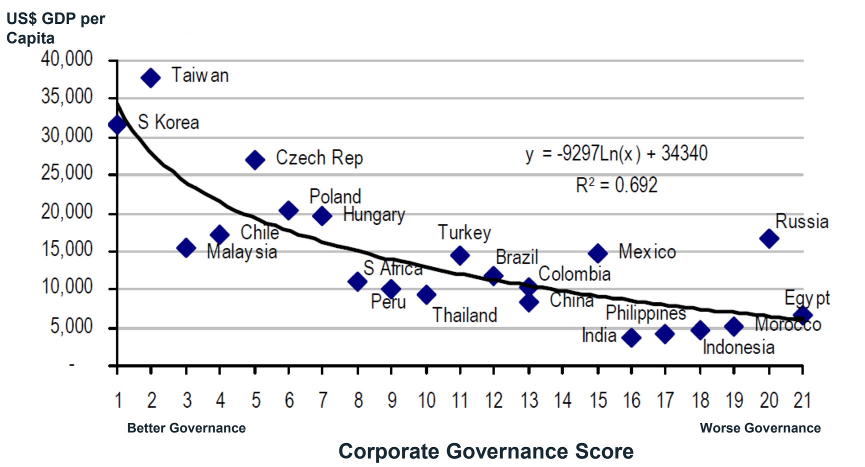



Source: FMR, as of 7/31/13 – MSCI Emerging Markets and MSCI Emerging Markets Small and Mid Cap Index



# Limiting Portfolio Downside Risk

## Don't ignore the impact of corporate governance



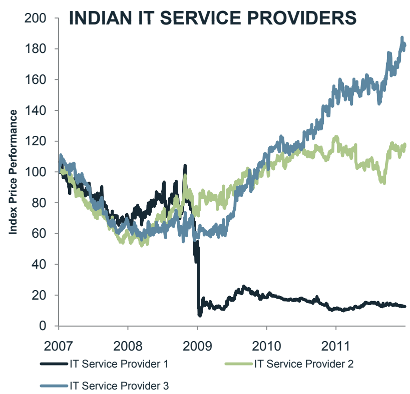

- **Governance affects economic growth**
- **But market participants can be fickle in applying this factor to company valuations**

Source: UBS "Governance in GEM: a Slippery Slope", May 22, 2013

# Limiting Portfolio Downside Risk

## Poor Corporate Governance Can Destroy Capital

| Related Party | Capital Misallocation | Political Affiliations | Poor Disclosure | Governance Structure |
|---|---|---|---|---|




- There were quite a few red flags
  - composition of the board was not ideal,
  - there were a lot of other businesses either controlled by the Chairman or his family which benefitted directly from his relationship with local politicians
  - the company was very aggressive in its pricing, yet showed comparable operating profit margins vs. its peer group.
- In late 2008/early 2009: The chairman surrendered to police along with his brother and admitted to inflating the company's operating profit for the 3rd quarter of 2008

Source: Factset, December 2011
Example of investment research process is shown for illustrative purposes only and is not representative of manager's entire portfolio or all recommendations for time periods shown. Not a recommendation or offer to buy or sell any securities. Past performance of investment research process is no guarantee of future results.



# Limiting Downside Risk in a Stock

## Focus on the right kind of companies and management teams

### Companies of interest

- Companies with good sustainable cash flow returns and steady growth
- Temporarily out-of-favour companies, with strong balance sheets, run by competent management teams
- Companies well below their intrinsic value leaving a reasonable margin of safety

### Companies to be avoided

- Companies with unsustainable growth and returns profiles, especially when they are priced for perfection
- Business models subject to obsolescence risk due to a technology or fashion going out of favour
- Companies without tangible cash flows or with poor history of generating cash flow returns
- Companies with weak corporate governance structures, or management teams with poor records regarding the treatment of minority share holders

**Keep a significant margin of safety over intrinsic value**

# Summary



# Summary

| Emerging Markets offer a great potential for investors despite having certain challenges | Investment approach with strong emphasis on downside protection has proven to work very well in these markets | Key to a low risk investment strategy is focus on good quality companies with steady returns and good corporate governance |
|---|---|---|
| • We are at a unique point in history where we are seeing countries with large populations driving high GDP growth rates<br>• EM is inefficient, opportunity for active investors<br>• But investors face multiple challenges ranging from poor governance to high volatility while investing in these countries | • Protecting capital at the time of market draw-downs is the key to generate higher compounded returns over time<br>• Hence a low risk investment approach focused on downside protection has outperformed benchmarks in Emerging Markets over a long period | • At the stock level, favor steady returns generating companies, run by competent and honest management teams; ensuring a significant margin of safety on valuation when investing in these stocks<br>• At portfolio level, this means favoring more domestically oriented sectors such as Consumer, and diversifying the portfolio across the whole range of Emerging Markets |

For illustrative purposes only.

# Important Information

For Institutional Use Only

# Important Information

Read this important information carefully before making any investment. Speak with your relationship manager if you have any questions.

Risks

Past performance is no guarantee of future results. An investment may be risky and may not be suitable for an investor's goals, objectives and risk tolerance. Investors should be aware that an investment's value may be volatile and any investment involves the risk that you may lose money. Performance results for individual accounts will differ from performance results for composites and representative accounts due to factors such as portfolio size, account objectives and restrictions, and factors specific to a particular investment structure.

The value of a strategy's investments will vary day to day in response to many factors, including in response to adverse issuer, political, regulatory, market or economic developments. The value of an individual security or a particular type of security can be more volatile than the market as a whole and can perform differently from the value of the market as a whole.

The performance of fixed income strategies will change daily based on changes in interest rates and market conditions and in response to other economic, political or financial developments. Debt securities are sensitive to changes in interest rates depending on their maturity, and may involve the risk that their prices may decline if interest rates rise or, conversely, if interest rates decline, their prices may increase. Debt securities carry the risk of default, prepayment risk and inflation risk. Changes specific to an issuer, which may involve its financial condition or economic environment, can affect the credit quality or value of an issuer's securities. Lower-quality debt securities are often considered to be speculative and involve greater risk, especially in periods of general economic difficulty. The value of mortgage securities may change due to shifts in the market's perception of issuers and changes in interest rates, regulatory or tax changes.

Derivatives may be volatile and involve significant risk, such as credit risk, currency risk, leverage risk, counterparty risk and liquidity risk. Using derivatives can disproportionately increase losses and reduce opportunities for gains in certain circumstances. Investments in derivatives may have limited liquidity and may be harder to value, especially in declining markets.

The performance of international strategies depends upon currency values, political and regulatory environments, and overall economic factors in the countries in which they invest. Foreign markets, particularly emerging markets, can be more volatile than the U.S. market due to increased risks of adverse issuer, political, regulatory, market, or economic developments and can perform differently from the U.S. market. The risks are particularly significant for strategies that focus on a single country or region.

# Important Information (continued)

These materials contain statements that are "forward-looking statements," which are based on certain assumptions of future events. Forward-looking statements are based on information available on the date hereof, and Pyramis does not assume any duty to update any forward-looking statement. Actual events may differ from those assumed. There can be no assurance that forward-looking statements, including any projected returns, will materialize or that actual market conditions and/or performance results will not be materially different or worse than those presented.

Performance Data

Performance data is generally presented gross of any fees and expenses, including advisory fees, which when deducted will reduce returns. See the GIPS® Composite Performance Data for performance figures that are net of the maximum investment advisory fee charged any client employing this strategy. Some clients may request a performance fee arrangement, which if imposed will also reduce returns when deducted. See Pyramis' Form ADV for more information about advisory fees if Pyramis Global Advisors, LLC is the investment manager to the account. For additional information about advisory fees related to other Pyramis advisory entities, speak with your relationship manager. All results reflect realized and unrealized appreciation and the reinvestment of dividends and investment income, if applicable. Taxes have not been deducted. In conducting its investment advisory activities, Pyramis utilizes certain assets, resources and investment personnel of FMR Co., which does not claim compliance with the Global Investment Performance Standards (GIPS®).

Representative account information is based on an account in the subject strategy's composite that generally reflects that strategy's management and is not based on performance of that account. An individual account's performance will vary due to many factors, including inception dates, portfolio size, account guidelines and type of investment vehicle. Index or benchmark performance shown does not reflect the deduction of advisory fees, transaction charges and other expenses, which if charged would reduce performance. Investing directly in an index is not possible.



# Important Information (continued)

The business unit of Pyramis Global Advisors (Pyramis) consists of: Pyramis Global Advisors Holdings Corp. , a Delaware corporation; Pyramis Global Advisors Trust Company, a non-depository trust company (PGATC); Pyramis Global Advisors, LLC, a U.S. registered investment adviser (PGA LLC); Pyramis Canada ULC, an Ontario registered investment adviser; Pyramis Global Advisors (UK) Limited, a U.K. registered investment manager (Pyramis-UK); Pyramis Global Advisors (Hong Kong) Limited, a Hong Kong registered investment adviser (Pyramis-HK); Pyramis Distributors Corporation LLC, a U.S. registered broker-dealer; and Fidelity Investments Canada ULC, an Alberta corporation (FIC). Investment services are provided by PGATC, PGA LLC, Pyramis Canada ULC, Pyramis-UK and/or Pyramis-HK.

"Fidelity Investments" refers collectively to FMR LLC, a US company, and its subsidiaries, including but not limited to Fidelity Management & Research Company (FMR Co.) and Pyramis. "Fidelity International" refers collectively to FIL Limited, a non-US company, and its subsidiaries. "Fidelity" refers collectively to Pyramis and Fidelity Investments.

Products and services presented here are managed by the Fidelity Investments companies of Pyramis Global Advisors, LLC, a registered investment adviser, or Pyramis Global Advisors Trust Company, a non-depository limited purpose trust company. Pyramis products and services may be presented by Fidelity Investments Institutional Services Company, Inc., Fidelity Investments Canada ULC, Fidelity International, Fidelity Brokerage Services, LLC, Member NYSE, SIPC, all non-exclusive financial intermediates that are affiliated with Pyramis.

Certain data and other information in this presentation have been supplied by outside sources and are believed to be reliable as of the date of this document. Data and information from third-party databases, such as those sponsored by eVestment Alliance and Callan, are self-reported by investment management firms that generally pay a subscription fee to use such databases, and the database sponsors do not guarantee or audit the accuracy, timeliness or completeness of the data and information provided including any rankings. Rankings or similar data reflect information at the time rankings were retrieved from a third-party database, and such rankings may vary significantly as additional data from managers are reported. Pyramis has not verified and cannot verify the accuracy of information from outside sources, and potential investors should be aware that such information is subject to change without notice. Information is current as of the date noted.

Pyramis has prepared this presentation for, and only intends to provide it to, institutional, sophisticated and/or qualified investors in one-on-one or comparable presentations. Do not distribute or reproduce this report.

 Pyramis does not provide legal or tax advice and we encourage you to consult your own lawyer, accountant or other advisor before making an investment.