VIEW FROM THE TRENCHES

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From time to time during periods of market dislocations, Pavilion interviews a select group of the industry's most talented managers to gain knowledge of the risks and opportunities they see as they go about researching companies and markets around the globe. Our focus during the most recent of these interviews was emerging market equities. During 2013, emerging market equities returned -2.3% while the S&P 500 returned 32.4% and the MSCI EAFE returned 22.8%. While all equity markets have declined thus far in 2014, the damage has been a bit worse for emerging market equities. Below is a summary of the managers' collective views on areas of opportunity and risk.

U.S. Equity

Managers viewed the U.S. equity market correction as long overdue and quite welcome. Growth style managers note that earnings have continued to come in strong and are 25-30% higher than they were at the prior peak six years ago. From their perspective, valuations appear fair given earnings quality and company growth prospects. During 2013, value style managers had an increasingly difficult time finding new opportunities and let cash build up as they sold stocks that reached valuation targets. The recent market pullback has allowed value managers to invest in some new ideas. While value managers do not appear as excited about market prospects, they believe reasonable returns can be achieved going forward, suggesting fair pricing. Interestingly, one of the more defensively oriented global managers we spoke with stated that the U.S. equity market remains the most defensive place to invest today.

International Equity

With economic growth returning in Europe, stabilization in the periphery countries, a more buoyant M&A and IPO market, and positive fund flows, managers see continental Europe as offering better opportunities going forward. Managers also point to valuations, as Europe trades at a discount to the U.S. market on a cyclically adjusted price/earnings basis. Managers appear less convinced on Japan, generally expressing surprise at the faith investors have placed in Prime Minister Shinzo Abe's three powerful "arrows". A great deal of money has moved into Japanese stocks and expectations are high. As investors shift their focus in Japan to structural reforms, shareholder returns, and M&A activity, more attention will be paid to individual company operating and stock price performance rather than the currency-driven macro story of the past 18 months.

Emerging Market Equity

Mixed views exist among emerging markets equity managers. It has been a challenge for defensively oriented managers to find stocks fitting their investment criteria. Pessimism surrounding the Fed taper, capital outflows, the slowdown in China, declining corporate profitability, and political unrest contribute to increased uncertainty. It has kept a number of managers in the same defensively-oriented names, pushing valuations into expensive territory. Managers mentioned the "crowded trade" of defensive stocks several times. While not all managers are convinced that market pessimism is fully priced in, those taking a long-term view believe that emerging markets appear attractively valued relative to their own history and other markets, and are finding opportunities in some of the hardest hit markets. These managers also believe that declining profitability forces companies to make better capital allocation decisions that benefit growth over time. Overall, they believe the long-term case for emerging markets remains intact.

Bottom-line: To quote John Templeton, "The time of maximum pessimism is the best time to buy and the time of maximum optimism is the best time to sell." Long time emerging markets equity investors bear the bruises of the roller coaster ride that can be had in EM. Although sentiment remains negative, that can change quickly, and valuations look cheap relative to the U.S. and foreign developed equity markets. As our global macro team points out, the last time emerging market valuations were this cheap was during the past two recessions and during the 1998 Russian financial crisis.