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WEEKLY INVESTOR RESEARCH

Ashmore

How incentives shape EM coverage

By Jan Dehn

Emerging Markets (EM) – equities and bonds in both US Dollar and local currency – are yet again this year the best performing asset classes in global financial markets. Yet, one can be forgiven for having missed EM's solid performance on account of the prominence given to negative stories in EM. Let there be no doubt: the media and banks serve essential functions in the operation of markets, including EM. However, their priorities, especially during period of heightened anxiety, are often very different from those of investors. While media and banks naturally gravitate towards stoking momentum and highlighting bad news, investors typically look for deep value and resilience. Investors will certainly benefit from bank and media coverage of EM in all states of the world, but for investors the key to success is to keep it real: to focus on the numbers and to identify value, to understand incentive structures and to be active with a key focus on liquidity. And never to lose sight of the fact that the EM asset class is now a highly diverse USD 53trn investment universe, which consists of far more than a few colourful countries in the grip of some temporary bout of dysfunctionality.

Emerging Markets	Next year forward PE/Yield	Spread over UST	P&L (5 business days)
MSCI EM	12.1	–	1.57%
MSCI EM Small Cap	13.1	–	1.55%
MSCI Frontier	12.0	–	1.10%
MSCI Asia	12.6	–	1.73%
Shanghai Composite	13.0	–	-0.86%
Hong Kong Hang Seng	8.1	–	2.58%
MSCI EMEA	10.6	–	1.39%
MSCI Latam	13.9	–	1.56%
GBI-EM-GD	6.24%	–	1.32%
ELMI+	3.48%	–	1.06%
EM FX spot	–	–	1.09%
EMBI GD	5.28%	292 bps	0.39%
EMBI GD IG	4.05%	167 bps	0.31%
EMBI GD HY	6.61%	428 bps	0.47%
CEMBI BD	5.06%	279 bps	0.23%
CEMBI BD IG	4.13%	187 bps	0.22%
CEMBI BD Non-IG	6.32%	404 bps	0.24%

Global Backdrop	Next year forward PE/Yield/Price	Spread over UST	P&L (5 business days)
S&P 500	17.7	–	0.67%
1-3yr UST	1.76%	–	-0.02%
3-5yr UST	2.08%	–	-0.01%
7-10yr UST	2.35%	–	0.16%
10yr+ UST	2.77%	–	0.73%
10yr+ Germany	0.36%	–	0.54%
10yr+ Japan	0.04%	–	0.07%
US HY	5.72%	354 bps	0.44%
European HY	2.70%	334 bps	0.32%
Barclays Ag	–	252 bps	0.30%
VIX Index*	9.67	–	-2.09%
DXY Index*	92.83	–	-1.25%
EURUSD	1.1920	–	1.59%
USDJPY	111.39	–	-1.09%
CRY Index*	192.22	–	3.97%
Brent	63.7	–	2.43%
Gold spot	1291	–	1.07%

Note: Additional benchmark performance data is provided at the end of this document. *See last page for index definitions.

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It is all too easy for EM investors to miss the forest for the trees. For entirely understandable reasons both the media and market-making banks have strong incentives to highlight sensational stories, which tend almost invariably to be negative in tone. Yet, to focus too much on the inevitable few colourful stories within the vast diverse USD 53trn EM investment universe carries the risk of missing the bigger picture, namely that this year EM has once again been the best performing asset class in the word. Media coverage and bank analysis is crucial for the efficient operation of markets, even EM. However, it is important to remember that what the media and banks want to deliver and what investors need are often very different things, especially during bouts of risk aversion, be they global or country specific. The truth is that bad news and momentum help media and banks to make money, but the associated markets over-reaction can often lead to serious mispricing, which then presents buying opportunities. Investors often need very different types of information from what the media and banks provide to make investment decisions at such times. In this Weekly we outline how incentives differ for the media and banks on the one hand and investors on the other during bouts of risk aversion, and why it is important to recognise these differences in order to successfully invest in EM, the world's most inefficient asset class.

Negative EM headlines are never few or far between and always outnumber the positive headlines. We are reminded daily that Turkey is struggling to defend its currency and that Venezuela is struggling to service debt. We are told to be alarmed at the rise in Chinese government bond yields and to worry about the pressure on the Mexican Peso. Saudi Arabia's internal political transition is portrayed as very risky and the country's conflicts with several neighbours poses major risks to regional and even global stability. Romania and South

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Africa's fiscal challenges could, we are reminded, yet morph into something far, far worse. The plethora of negative news gives investors plenty of reasons to be cautious about investing in the asset class.

Yet, do the headlines give a fair reflection of the reality in EM? Despite the negative headlines listed in the previous paragraph, EM is now closing in on a second consecutive year of very solid returns, including material outperformance versus developed markets. This is illustrated in the table below, which shows returns (in US Dollar terms) for EM's main fixed income, credit, currency and stock markets for 2016 and 2017 YTD alongside returns for the corresponding markets in developed economies.

Fig 1: **Performance 2016-2017 YTD 27-Nov-17: EM versus selected developed markets**

	% return (USD terms)		
Sub-asset class	**2016**	**2017 ytd**	**Combined 2016-2017**
Fixed income			
EM local currency bonds	**9.94%**	**12.77%**	**22.72%**
3-5yr UST	*1.33%*	*1.24%*	**2.57%**
EM external debt (USD)	**10.15%**	**9.43%**	**19.58%**
7-10yr UST	*1.04%*	*2.90%*	**3.94%**
Credit			
EM corporate debt (USD)	**9.65%**	**7.60%**	**17.26%**
EM HY (USD)	**16.21%**	**10.19%**	**26.40%**
US HY	**16.96%**	**7.05%**	**24.01%**
EU HY	**5.91%**	**6.08%**	**11.99%**
Currencies			
EM FX	**0.54%**	**4.98%**	**5.52%**
*DXY Index**	*0.53%*	*-9.18%*	**-8.65%**
EURUSD	*-0.55%*	*13.31%*	**12.76%**
USDJPY	*0.58%*	*-4.79%*	**-4.21%**
Stocks			
EM stocks	**11.27%**	**36.82%**	**48.09%**
EM Small cap	**0.27%**	**30.04%**	**30.31%**
Frontier Markets	**-1.28%**	**27.44%**	**26.16%**
US stocks	*11.95%*	*18.36%*	**30.31%**

Source: Ashmore, Bloomberg, JP Morgan, MSCI, Barclays

EM local government bond returns are nearly ten times higher than US markets of the same duration. EM external debt has returned more than five times more than US government bonds of the same duration. EM large cap stocks markets have outperformed US stocks by more than half, while EM small cap is performing in line with the S&P 500. EM Frontier Markets are not far behind. EM currencies are outperforming the US Dollar for the second year in a row and EM corporate high yield bonds are beating US high yield bonds, while still paying higher yields and sustaining lower default rates than US HY corporate bonds.

There is no doubt that the media and bank analysts contribute positively to the information flow in EM. Investors should be grateful that journalists and bank analysts closely monitor their markets. However, it is also crucial to understand the big differences between what the media and banks deliver in terms of information during bouts of stress and what investors actually need in terms of information in order to make sound investment decisions.

Consider the media first. As every honest journalist will readily admit, bad news sells. If the bad news also happens to coincide with falling asset prices then even better. When a sense of panic is created the demand for information skyrockets and media frenzies can arise. During such frenzies there are strong incentives for editors to highlight news, which sustains the frenzy.

Now consider the incentives facing market-making banks during periods of risk aversion. Prior to the introduction of Dodd-Frank legislation, banks would be able to hold large positions on their balance sheets. Good market-makers would be allowed to add to positions during periods of market stress, i.e. buy on dips. Today, however, market-makers typically have very small balance sheets and mainly make money by inducing their clients to trade more frequently, that is, to get clients to cross the bid offer spread. Every time a trade occurs the bank pockets the bid/offer spread.

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In other words, both the media and banks have strong incentives to maximise the significance of events and to amplify market momentum. They understand that there are very few things more disconcerting for investors than to sit on long positions at a time of crashing prices and a cacophony of negative headlines. They understand that weak hands may capitulate and the resulting selling may deepen the sense of gloom even further. This is not to criticise the media and the banks for thinking this way. They are clearly incentivised to exploit weakness and panic. They are acting in accordance with what makes financial sense from their own narrow perspective.

Now consider the needs of investors during bouts of risk aversion. Investors are *not* particularly interested to know that prices are falling, because the price action is available on the screens. Nor do investors want to be reminded of fundamental stresses, which are already known. Instead, they are interested to know just how resilient a credit will be, despite the fundamental stresses. Most important of all, investors want to know about the willingness to pay. The most successful investments are made precisely during periods of maximum stress, and the art of investing is to identify the survivors. In the case of investments, this means identifying those situations where prices have moved the most out of line with actual risks. In other words, investors often find themselves looking for the type of information that can help them decide to make a purchase precisely when the media and banks seek to deliver maximum hyperbole in favour of selling.

The empirical evidence is fairly unambiguously in favour of buying during periods of stress. For example, investors who have systematically bought EM during spikes in the US equity options volatility index (VIX) have consistently harvested significant alpha across all the main EM asset classes.[1] Even when EM crises have been country specific in nature the movement in asset prices has often been wildly excessive relative to the deterioration in fundamentals. The massive over-reaction in Russian sovereign debt markets in late 2014 is a perfect example.

The importance of being aware of media and investment bank incentives during bouts of risk aversion becomes even more clear when one considers that the mispricing is both more frequent and more violent in EM compared to other asset classes. There are at least three reasons for this.

First, markets generally tend to underestimate fundamental resilience in EM. There is still very scant recognition that most EM governments have very strong incentives to be prudent. Their populations are generally poor with neither effective inflation hedges nor access to social security and unemployment benefits. Governments wishing to stay in power must therefore try as hard as possible to avoid macroeconomic volatility, which would push large numbers of voters into abject misery and result in governments being ousted from power. EM countries demonstrated their fundamental resilience in recent years, which saw massive outflows, a halving of commodity prices, a surge in the Dollar and had de facto to price in a full normalisation of US monetary policy.

Second, price volatility is exacerbated by the inefficiency of benchmark indices in EM. The widespread practice of benchmark hugging means that the vast majority of capital flowing into EM ends up in the narrow sleeve of countries included in the benchmark indices. Both Citibank's WGBI and Barclays/Bloomberg Agg. indices assign far lower weights to EM than EM's actual share of global market cap, but even the specialist EM benchmark indices massively under represent the EM asset class. For example, only 9% of EM local currency bonds are represented in the JP Morgan GBI EM GD benchmark index. In total, across all of EM fixed income themes, some 92% of bonds are currently off-benchmark. Too much money is funnelled into too few countries and too little into the majority of countries.

Finally, the global regulatory system operates as a *de facto* apartheid system for global capital. It classifies EM issuers as 'risky', while developed market issuers are afforded 'risk free' status. There is no biological or other basis for such discrimination. Markets should be left to freely price all assets, regardless of whether they are issued by rich or poor countries. By pre-assigning a risky status to some countries, regulators in effect doom some countries to greater volatility during bouts of risk aversion, while others are given a de facto stability subsidy. The system is made doubly perverse by its reliance on credit rating agencies, because credit ratings agencies systematically assign the highest credit ratings to the most indebted, slowest growing and least reform-minded countries in the world, i.e. developed economies.

That is not to say that EM countries do not account for some of the volatility in the asset class. There are no risk free markets, even in EM. However, EM 'accidents' are typically isolated events – indeed, there has not be a conventional 'Soros style' contagion in EM since 1998.[2] The EM countries most at risk are authoritarian governments, because they rule with impunity, which can result in corruption and general political discontentment, which then suddenly erupts into political violence. Occasionally EM countries elect far from ideal candidates as presidents or make major policy mistakes exactly like in developed countries. EM countries can also fall victim to supply-side shocks, which can be tougher to handle since EM countries have lower per capita GDP, shallower financial markets and less diversified economies. Still, the vulnerability to external

[1] See *'VIX spiked 10 points in June – it is a good time to allocate to EM*, Weekly Research, 11 July 2016.

[2] Soros style contagion events are crisis, which are trigged by selling in financial markets, which tend to morph into fundamental crises, which tend spread from country to country until the entire asset class is brought down both financially and economically. The last such crises date back to the 1997 and 1998 Asian and Russian crises.

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shocks is in rapid decline across the asset class as more and more EM countries industrialise. Today, for example, two thirds of EM countries import commodities rather than export them. Also, EM indices are now so diverse that problems, which arise in a single country, typically have much smaller impact at portfolio level than in the past.

A quick reminder of the status of EM today: EM countries today make up 60% of global GDP. EM tradable financial markets now measure USD 53trn comprising just over USD 20trn in fixed income and some USD 33trn in listed stocks. EM therefore makes up about 25% of the combined global fixed income and stock market capitalisation. The EM investment universe is also far more diversified than anything on offer in developed economies. There are nearly 70 countries represented in the main fixed income benchmark for US Dollar sovereign bonds and some 61 countries in the broadest EM corporate benchmark, which comprises more than 1000 individual corporate names and some 2500 bonds. But these markets are dwarfed by the local currency markets, which are many times larger and even more diverse. In the equity universe there are now 22 countries in the Frontier Market index and 24 countries in the main MSCI EM index with even larger tradable off-benchmark opportunities, including prominent countries such as China and India.

EM accidents are relatively rare today. This is not surprising given the many improvements in governance and economic strength and markets over the past couple of decades. The bigger mystery is why it has taken so long for large sections of the finance industry, which is after all one of the most educated and best informed industries in the world, to catch up with this fact.

Until the inefficiencies in the asset class are ironed out investors must approach the asset class differently than other asset classes. Investors should always focus on the facts. Start with the numbers and seek to find value. Try to understand the incentives that drive policy-makers. Be very active and manage liquidity very carefully. Sentiment drives prices for a time, but otherwise plays very little part in proper investing and can in fact be a dangerous distraction. Too many investors sell at the bottom and buy at the top.

EM offers a rich opportunity set, which is far from defined by a few colourful accidents. The focus on these accidents, however, means that the asset class exhibits far more volatility than actual risk. It is precisely this quality, which EM investors seek to exploit. Such opportunities reach their maximum exactly at times, when media and banks are most dismissive of the asset class.

- South Africa: S&P downgraded South Africa's foreign and local currency ratings by one notch to sub-investment grade and placed the outlook on stable, while Moody's placed South Africa on ratings watch negative, but maintained its investment grade rating. This means that South African bonds are still eligible for inclusion in the WGBI index. However, the fact that the bonds are on ratings watch negative suggests that a downgrade will become a reality within months unless material changes take place. It is likely that Moody's is waiting for the outcome of the December ANC leadership contest and the Budget, which is due in February 2018. In other news, Fitch affirmed South Africa's sovereign rating at BB+ with stable outlook and the central bank left the policy rate unchanged at 6.75% as the core inflation rate dropped to 4.8% yoy in October from 5.1% in September.

- Venezuela: PDVSA, the national oil company, confirmed last week that the company continues to pay coupons, but that the coupon payments are held up with financial intermediaries due to US sanctions. Crystallex, a Canadian mining company, announced that it has reached a USD 1.2bn financial settlement with the government. In a cabinet reshuffle announced at the weekend President Nicholas Maduro placed Major General Manuel Quevedo in charge of PDVSA. More and more parts of the Venezuelan government have been put under military control as available industry sector talent has left the country or been caught up in corruption scandals.

- Argentina: The government published very positive fiscal numbers for October, including a 20% decline in the overall fiscal deficit relative to October 2016. The current account deficit widened to USD 6bn on 12m rolling basis in October, up from USD 5.1bn in September. The monthly GDP proxy (EMEA) was up 3.8% yoy in September. The Lower House approved the government's capital market reform, which removes powers by the National Securities Commission to intervene in companies. The central bank left the policy rate unchanged at 28.75%.

- Brazil: The government is making a final attempt before year end to pass the pension reform. Congress goes into recess on 22 December. The real rate of household credit growth rose to 2.9% yoy from 1.3% yoy in June. The current account deficit was smaller than expected (USD 343m versus USD 900m expected. This takes the deficit to a nine year low. Mid-month inflation was 0.32% (2.8% yoy) versus 0.38% mom expected.

- China: The small and medium sized enterprise index rose to 56.1 in November from 55.2 in October. Unwinding of positions in government bonds triggered by government efforts to deleverage the financial system has pushed the 10yr bond yield to 4%. Technical sell-offs of this nature are usually excellent buying opportunities. Industrial profits were 25.1% higher in October than in the same month of 2016.

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Snippets:

- **Chile:** The rate of real GDP growth accelerated to 2.2% yoy in Q3 2017 from 1.0% yoy in Q2 2017. The current account deficit narrowed to USD 1.5bn in Q3 2017 from USD 2.2bn in the same quarter last year.
- **Colombia:** The central bank cut the policy rate by 25bps to 4.75%.
- **Ecuador:** In a very positive development President Lenin Moreno has sacked economic officials from the previous Correa administration.
- **Hungary:** The central bank introduced measures to push monetary easing further out the yield curve, including long-dated interest rate swaps and a mortgage purchase program.
- **Kenya:** The central bank left the policy rate unchanged at 10%.
- **Malaysia:** CPI declined 0.2% mom in October, taking the yoy print to 3.7% versus 4.3% yoy expected.
- **Mexico:** Retail sales were softer than expected in September (-0.3% yoy versus +0.8% yoy expected).
- **Nigeria:** The central bank left the policy rate unchanged at 14%. The real economy expanded at a rate of 1.4% yoy in Q3 2017 compared to 0.7% yoy in Q2 2017.
- **Peru:** The month GDP proxy showed that Peru's economy was 2.5% stronger in Q3 2017 than in the same quarter last year. This was a gentle acceleration from Q2 2017, where growth was 2.4% yoy.
- **Poland:** Industrial production accelerated to 12.3% yoy in October from 4.3% yoy in September.
- **Romania:** In a report published last week Moody's praised Romania for its solid growth prospects, but highlighted recent fiscal measures as a potential risk to the consolidation achieved in recent years.
- **Singapore:** Industrial production was 14.6% higher in October than in the same month of 2016. Inflation was unchanged at 0.4% mom in October. Q3 2017 GDP was 8.8% qoq saar.
- **South Korea:** Exports were 9% higher in the first 20 days of November than a year ago compared to 7% yoy growth in October.
- **Sri Lanka:** S&P changed the outlook for Sri Lanka's sovereign credit rating (B+) to stable from negative.
- **Taiwan:** Industrial production increased at a rate of 2.85% yoy in October. Export orders were stronger than expected at 9.2% yoy.
- **Thailand:** Exports were 13.1% higher in October than in the same month of 2016. The economy was 4.3% bigger in Q3 2017 than in the same quarter of last year and stronger than Q2 2017 (3.8% yoy).
- **Turkey:** The central bank tightened liquidity in response to the rapidly weakening Lira, but with little impact. The central bank is afraid to hike rates, because President Erdogan says s that hiking rates increases inflation.
- **Zambia:** The central bank cut the policy rate by 75bps to 10.25%.
- **Zimbabwe:** Robert Mugabe resigned as President.

Global backdrop

In the US, the Dollar declined sharply last week following dovish comments about inflation from Fed Chairwoman Janet Yellen and in the FOMC minutes. The main economic releases were also disappointing at the margin. US new durable goods orders declined 1.2% in October, while the University of Michigan's long-term inflation expectations index declined by 0.1% to 2.4%. The Markit PMI numbers were also lower than expected. The Fed has already embarked on a rate hiking cycle even though inflation has so far failed to pick up (in spite of lower unemployment). The Fed's decision to embark of rate hikes before evidence that inflation is picking up – indeed at a time when FOMC members openly admit that they do not know why inflation remains low – naturally makes US rates and the Dollar more risky compared to Europe, where the ECB has been quite explicit that it will not touch rates until 2019 at the earliest. Meanwhile, sentiment in Europe continues to improve. Prospects for a German coalition government are getting better and Europe's economy continues to do well. European PMIs were strong (57.5 versus 56 expected) and German Q3 2017 GDP growth was solid at 3.3% qoq saar. The UK government presented its Budget last week, which embedded materially lower growth projections as the full ramifications of Brexit begin to make themselves felt. Oil drifted higher last week but has weakened this morning ahead of a meeting of OPEC scheduled for Thursday this week.

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Benchmark performance

Emerging Markets	Month to date	Year to date	1 year	3 years	5 years
MSCI EM	3.18%	36.82%	39.00%	7.33%	5.81%
MSCI EM Small Cap	2.39%	30.04%	31.56%	6.32%	6.27%
MSCI Frontier	0.86%	27.44%	29.76%	2.15%	9.13%
MSCI Asia	3.80%	42.60%	41.85%	10.63%	9.42%
Shanghai Composite	-1.16%	10.29%	5.59%	11.89%	13.25%
Hong Kong Hang Seng	3.48%	31.83%	27.96%	7.09%	6.40%
MSCI EMEA	3.41%	16.99%	25.92%	-0.35%	-0.08%
MSCI Latam	0.49%	23.04%	25.88%	-0.39%	-2.02%
GBI EM GD	1.54%	12.77%	15.94%	-0.49%	-1.43%
ELMI+	1.69%	10.58%	11.65%	0.65%	-0.47%
EM FX Spot	1.48%	4.98%	6.45%	-6.44%	-6.88%
EMBI GD	0.03%	9.43%	10.86%	6.08%	4.73%
EMBI GD IG	0.39%	8.74%	9.54%	4.53%	3.31%
EMBI GD HY	-0.31%	10.19%	12.33%	7.60%	6.55%
CEMBI BD	0.02%	7.60%	8.59%	5.49%	4.85%
CEMBI BD IG	0.02%	6.08%	6.52%	4.13%	3.96%
CEMBI BD Non-IG	0.01%	9.88%	11.72%	7.43%	6.30%

Global Backdrop	Month to date	Year to date	1 year	3 years	5 years
S&P 500	1.24%	18.36%	20.44%	10.21%	15.43%
1-3yr UST	-0.16%	0.46%	0.55%	0.58%	0.60%
3-5yr UST	-0.18%	1.24%	1.27%	1.33%	1.08%
7-10yr UST	0.22%	2.90%	2.52%	2.15%	1.51%
10yr+ UST	1.89%	8.05%	7.25%	4.23%	3.10%
10yr+ Germany	0.30%	-1.71%	-1.73%	4.21%	5.71%
10yr+ Japan	0.60%	0.18%	-0.74%	4.93%	5.06%
US HY	-0.38%	7.05%	9.28%	5.66%	6.19%
European HY	-0.37%	6.08%	8.27%	5.69%	7.63%
Barclays Ag	0.14%	5.28%	6.14%	3.97%	3.86%
VIX Index*	-5.01%	-31.13%	-21.64%	-19.88%	-39.26%
DXY Index*	-1.83%	-9.18%	-8.54%	5.96%	15.45%
CRY Index*	2.48%	-0.15%	3.49%	-27.91%	-35.45%
EURUSD	2.35%	13.31%	12.36%	-4.39%	-7.90%
USDJPY	-1.98%	-4.79%	-0.49%	-5.36%	35.58%
Brent	3.85%	12.16%	34.91%	-12.19%	-42.00%
Gold spot	1.53%	12.00%	8.09%	8.35%	-25.92%

*VIX Index = Chicago Board Options Exchange SPX Volatility Index. *DXY Index = The Dollar Index. *CRY Index = Thomson Reuters / CoreCommodity CRM Commodity Index.
Source: Bloomberg, JP Morgan, Barclays, Merrill Lynch, Chicago Board Options Exchange, Thomson Reuters, MSCI, total returns.
Figures for more than one year are annualised other than in the case of currencies, commodities and the VIX, DXY and CRY which are shown as percentage change.

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Ashmore

Contact

Head office

Ashmore Investment Management Limited
61 Aldwych, London
WC2B 4AE

T: +44 (0)20 3077 6000

@AshmoreEM

www.ashmoregroup.com

Bogota
T: +57 1 316 2070

Dubai
T: +971 440 195 86

Jakarta
T: +6221 2953 9000

Mumbai
T: +91 22 6608 0000

New York
T: +1 212 661 0061

Riyadh
T: +966 11 483 9100

Singapore
T: +65 6580 8288

Tokyo
T: +81 03 6860 3777

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