Ashmore

# Latin America – 20 years of investing in Small Caps

By Julie Dickson, CFA

## Introduction

This month Ashmore celebrates 20 years of investing in Latin American smaller companies.

In that time we have seen a huge transformation and expansion of stock markets across the region. It has not always been a smooth ride – often marked by economic meltdown, political drama and violent unrest – but we believe markets are structurally more sound, have better governance and offer an attractive investment proposition.

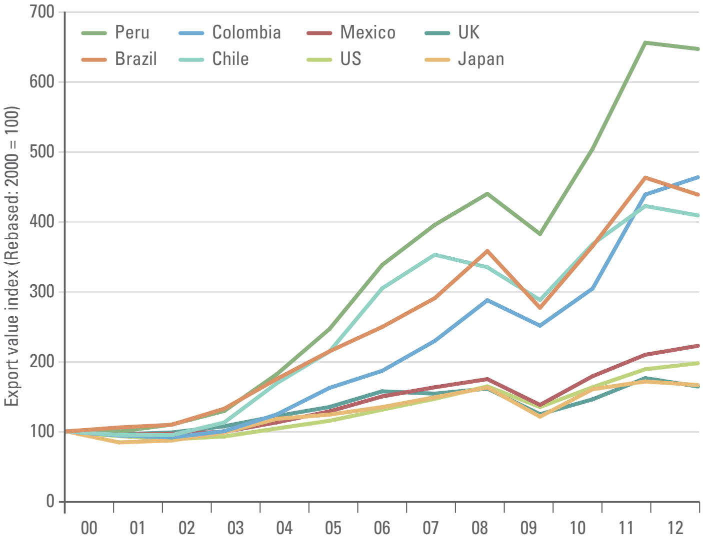
We review the progress over the past two decades and consider the investment opportunity the region now represents.

It's 1994. Emerging Markets (EM) are going through major social and political upheaval. Nelson Mandela is elected president of South Africa in landmark elections, conflict erupts between Russia and Chechnya and – closer to home for Latin America – the North American Free Trade Agreement (NAFTA) has been signed between Mexico, the US and Canada.

The next 10 years see a sweep in reform and political transformation across the Latin American region. In Brazil, newly elected president Fernando Cardoso introduces measures to begin selling government-owned monopolies in telecommunications, electrical power, mining, railway, ports and banks, resulting in a massive boom in market cap for the Brazilian equity markets. In Mexico, following the introduction of NAFTA, the US intervenes to shore up Mexico's private banks in response to a massive Peso devaluation, leading to virtual control of Mexico's economic policy until the then-incumbent PRI (Institutional Revolutionary Party) loses general elections to Vicente Fox's National Action Party for the first time in 71 years. Argentina is reeling from austerity measures introduced by Peronist President Carlos Menem in an attempt to bring massive inflation and public debt under control, eventually succumbing to its worst recession in a decade and largest sovereign debt default in history. In the Andean region, notably Colombia, Peru and Chile, transformation is equally dramatic if not violent. Colombia is fast becoming the capital of illegal drug trafficking and is virtually controlled by powerful drug cartels. Chile is recovering from 17 years of violent and oppressive rule under Pinochet. Peru is also facing upheaval from the de-facto war between the government and rebel Maoist and drug trafficking groups, with a succession of political leaders each facing a series of scandals and corruption. Venezuela is included in the MSCI EM Latin American index.

Forward another 10 years and, despite recent geopolitical news, there is much to celebrate in the region. Mexico has blazed a path of far-reaching reforms, while Brazil's political parties have been given a wake-up call by strong popular support for economic change. Across the region, the local institutional investor base is growing as a result of increased pension fund investment, supporting an ever evolving market. While many of the Latin American economies are still strongly exposed to natural resources, some, such as Peru, have taken steps to introduce further diversification. Major projects are underway to improve local infrastructure and business activity is picking up. The region has taken significant steps to get inflation under control. Whereas today's inflation levels are at approximately 7% for the region, this pales in comparison to nearly 200%-plus levels experienced in 1994. Figure 1, below, shows the Export Value Index for Latin American countries compared to the US, UK and Japan as of 2000 through to 2012 (in 2000 the index level begins at 100). Despite the headwinds faced in the 2008 Global Financial Crisis, the region has continued to expand its export trade activity – in many cases exceeding the growth of its developed peers.

Fig 1: **Expanding export values**




Source: Ashmore, World Bank. Latest data available at time of writing.

## The equity opportunity – our outlook for the region

One of the key benefits of investing in Latin America is that markets and local economies are far from homogeneous. While the political and macro-economic outlook for Argentina remains somewhat murky, the country remains 'off-benchmark' for Emerging Markets equity investors, and the lack of index coverage means the market is trading at a valuation discount to its regional peers. Argentina is currently trading at a forward Price to Earnings ratio of 7.8x vs 10.5x for its EM brethren, according to MSCI. Furthermore, with Argentina holding presidential elections next year without incumbent President Cristina Fernandez de Kirchner, we anticipate a more market-friendly government to step in and introduce much needed reform.

In the face of a weakened currency and weak industrial production in **Brazil**, earnings – and valuations – are at historic troughs. In the wake of recent elections, we expect that the government will be forced to introduce some level of reform and that industrial companies will be among the key beneficiaries.

In **Mexico**, markets have been more buoyant as investors have responded strongly to the pace of reform. This has led valuations to become somewhat stretched, so stock selection through rigorous analysis will be critical to outperformance. We are finding opportunities in the automotive space and industrial real estate.

**Chile** continues to go through a period of macro-economic adjustment following weak copper prices and currency devaluation, while at the same time pursuing labour-friendly reforms including higher taxes. We remain positive as the country continues to push through education and health care reforms. The market has corrected sharply and we believe a turn in the earnings cycle is beginning to open up entry points into a previously expensive market.

After decades of socio- political violence and economic stagnation, **Colombia** is emerging as one of brightest spots in the region. A strong economic outlook, driven by a stable political framework and sound macroeconomic management, is supporting the rollout of an ambitious infrastructure investment plan. As a result, earnings across Colombia's financial, energy and industrial sectors are already indicating a cyclical uptick.

Like Chile, **Peru** remains vulnerable to commodity prices; however, we are finding opportunities in small caps.

Like much of the emerging world, Latin American countries have taken steps to make their corporate accounting more transparent. Over the years, there has been a concerted move across the region to adopt IFRS rules for corporate accounting by listed companies – providing investors with a common approach to evaluating the fundamental strength of companies across the market, and across peers around the world.

Furthermore, smaller markets such as Peru, Chile and Colombia took a significant step in 2011 by integrating stock trading from their local exchanges into a regional bourse called the Mercado Integrado Latinoamericano (MILA). MILA effectively became the second largest bourse after BOVESPA in Brazil with a combined market value of approximately USD 643 billion across over 560 listed companies. After its strong success over the last three years, plans are under way to connect Bolsa Mexicana de Valores, which doubles its size and brings it closer to that of Brazil.

Fig 2: **Increasing transparency across the region**

| Country | Exchange | IFRS Required? | Notes |
|---|---|---|---|
| **Argentina** | Bolsa de Comercio de Buenos Aires | Yes, except Financial Institutions & Insurance | Introduced in 2012, Financial Institutions regulation under review |
| **Brazil** | BOVESPA | Yes | Introduced in 2010 |
| **Chile** | Bolsa de Comercio de Santiago | Yes | 2012/2013 |
| **Colombia** | Bolsa de Valores de Colombia | No | Expected in 2015 |
| **Mexico** | Bolsa Mexicana de Valores | Yes, except Financial Institutions & Insurance | Financial Institutions regulation under review |
| **Peru** | Bolsa de Valores de Lima | Yes | Introduced in 2011 |

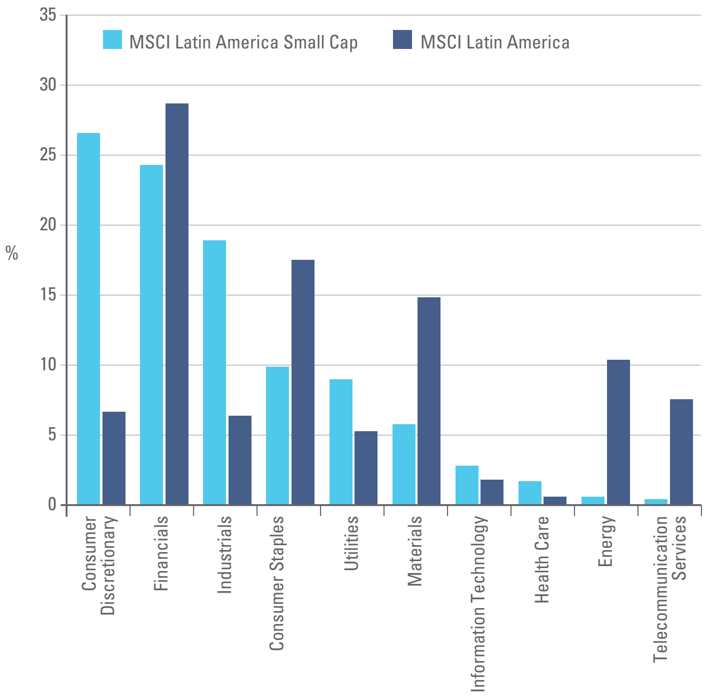
Source: PwC, Ashmore November 2014.

## One of the key benefits of investing in Latin America is that markets and local economies are far from homogeneous

### The small cap advantage in Latin America

Small caps in Latin America may provide the growth investors look for in EM. Unlike large caps, smaller companies are naturally better positioned to benefit from the economic growth and more business-friendly policies across the region. They have greater exposure to infrastructure and manufacturing, benefitting from investment in the likes of transportation and housing. Smaller companies tend to be the suppliers for construction materials, related valued added services and logistics for big government-funded infrastructure projects. In those economies where consumer spending is resilient – or even recovering – smaller businesses benefit from rising demand in private education, housing and travel. These tend to be niche players with dominant market share and which have been largely overlooked due to lower liquidity or index exclusion. This favours active stock selection, where a disciplined, bottom up research approach provides the framework for discovering these opportunities.

Fig 3: **Sector weights**




Source: Ashmore, MSCI as at 31 October 2014.

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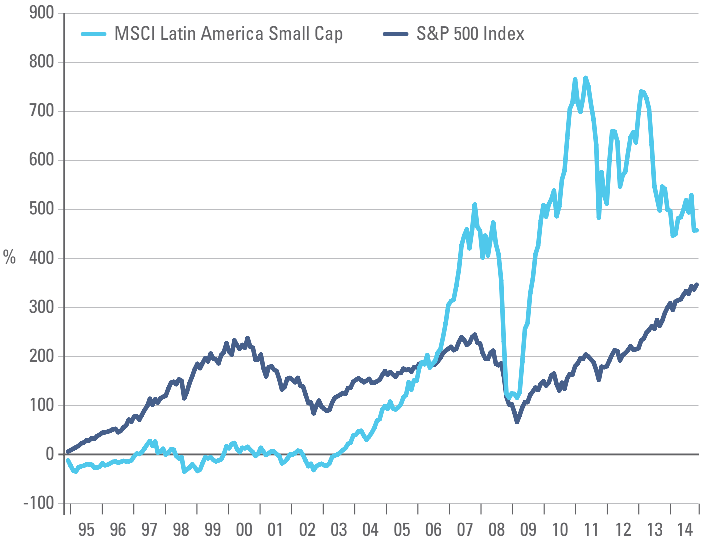
## Opportunity for superior returns

There is little doubt that small companies in Latin America can deliver. Over the last 20 years, in spite of several social revolutions, violent unrest and economic meltdowns, Latin American small caps have outperformed their northern neighbour – and continue to do so. According to the IFC Global Latin America Small Cap and the MSCI EM Latin America Small Cap indices, Latin America small caps have returned 457% compared to the S&P 500 return of 345%.*

Fig 4: **Cumulative returns in USD (1994 - 2014)**




*Source for both text and chart: Ashmore, Bloomberg, MSCI, from 30 November 1994 to 31 October 2014.

In our view, the upside is still significant. As of 31 October 2014, fundamentals are looking strong:

Fig 5: **Strong fundamentals**

| | MSCI Latin America Small Cap | MSCI Latin America Standard | MSCI US |
|---|---|---|---|
| **Forward Price/Earnings** | 11.8x | 12.4x | 16.0x |
| **Price to Book** | 1.3x | 1.7x | 2.8x |
| **Earnings Growth*** | 46% | 37% | 21% |
| **Dividend Yield (12 mths)** | 3.7% | 3.5% | 2.0% |

Source: MSCI, Ashmore. Earnings growth calculated based on MSCI published trailing and forward P/E multiples for MSCI LatAm Standard and S&P 500, and Ashmore estimates for Small Caps.

We believe Latin America small caps provide a unique opportunity to invest in what has been an out of favour investment region that is beginning to show signs of improvement. Unlike large caps, small caps are diverse, have greater exposure to sectors benefitting from domestic policy shifts, and can also provide exposure to regional exporters benefitting from a weakened home currency. As we look ahead into 2015, on the back of increasing reform and infrastructure spending, Latin American small caps may provide the catalyst for returns that have eluded Emerging Markets investors this year.

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