

Templeton Emerging Markets Investment Trust: Investment Update

Summary of webinar comments, 2 December 2016

SUMMARY

- Concerns around China, commodities, politics and currencies have all negatively impacted emerging markets.
- We believe there is a discrepancy between the perception of risks in emerging markets and fundamental economic realities.
- TEMIT is looking at companies within technology, small- and mid-sized companies and from within frontier markets.



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What's the state of emerging markets at the end of 2016?

Emerging markets have gone through a fairly long period of difficulties over the last five years for a number of reasons, including:

- **China**—which has had a slowdown in economic growth
- **Commodities**—Brent oil and Chinese-related commodities affected by a slowdown in global growth
- **Politics**—South Africa, the Middle East, Turkey and Brazil amongst others have had political crises, some of which are ongoing
- **Currencies**—emerging market currencies have depreciated, particularly in 2015

A combination of these factors has led to underperformance of emerging markets as an asset class. For emerging markets investors, the good news is we think that a lot of the negativity and risks we see in these markets are now represented in share prices, and we believe that valuations are very attractive.

We also believe there is a big discrepancy between the perception of risks in emerging markets, and in developed markets to some degree, and fundamental economic realities. The election win by Mr Trump created a lot of negative expectations for emerging markets, but if we go through the threats in detail, we see that the relationship between the US and many other markets is so deep that it is not in the interest of the US to cut trading relationships.

Could you give an example of the difference between perceived risk and “reality”?

Certainly, Mexico is a great example. Mr Trump is very interested in supporting local US industry and making some of the “champions” bigger and great again. The Mexican peso has been reflecting this increased risk perception and has depreciated against other currencies, including Latin American currencies.

But the Mexican economy is very integrated into the US economy with 81% of exports going to the US, and 52% of total imports coming from the US. Ford is one example that reflects this integration. They are increasing their investment in the US SUV manufacturing lines. But this increase is tiny compared to the investments they are making in Mexico: US\$1.6 billion alone in one plant in Mexico versus a couple of tens of millions in the US.

These discrepancies lead to opportunity, and as asset prices in Mexico have fallen, we have been adding some positions there. We have focused on high quality names, which have the best of both worlds, a fairly vibrant large domestic economy, but also a good position when it comes to exports out of Mexico – with the depreciated peso, the exporters, of course, are benefitting.

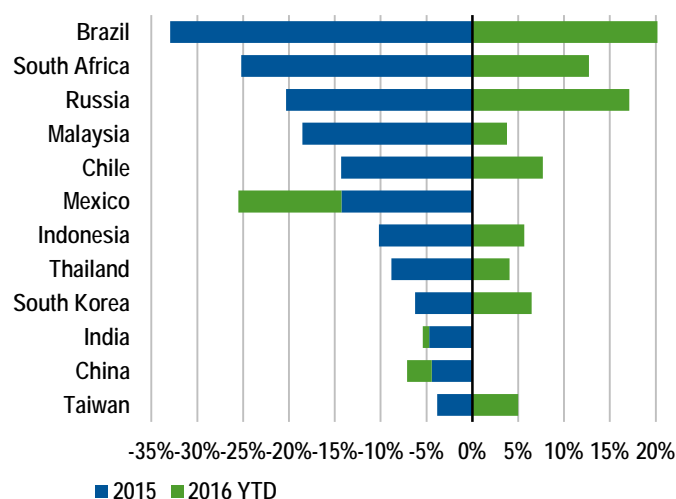
Could you comment on emerging market currencies?

Currencies have been at the forefront of the correction in emerging markets over the past years [see figure overleaf], but, in our experience currencies tend to overreact. Bond flows have recently been favouring the US with the expectation of a stronger dollar, so there is on-going pressure on domestic emerging market bonds, but we believe this is an overreaction, especially in 2015 where the Brazil real, the South African rand, the Russian rouble, all depreciated anywhere between 15% to 20% or 30% in one year alone. Then, in 2016, there was a mean reversion and some of these currencies have adjusted back to more realistically reflect the value and the potential of the underlying economies.

So this year we benefitted a lot from our positions in Brazil: we used the currency weakness to add positions to strong companies. Equally, in Russia, where we had built up three new positions over the course of the year and, again, we have been helped by currency swings, but also by good performance from the underlying companies. We

A Tale of Two Years

Emerging Markets Currency Performance: 2015 v 2016



For illustrative and discussion purposes only. Past performance does not guarantee future results. Source: FactSet, as of September 2016.

are also utilising the ongoing weakness of the Mexican peso. Finally Thailand, a traditional overweight in the portfolio, is one Asian example where we saw a good recovery of the currency.

What are the key risks in emerging markets?

When we look at the risks in emerging markets, the big question remains: what will be the effect of a stronger US dollar?

Emerging market companies and countries will be affected by a strengthening US dollar and there is an impact on commodity prices, but we see on average that emerging markets are better prepared than in previous phases of US dollar strength. This is because commodity prices have normalised, current accounts look much more robust than they have in the past and the local Central Banks have been doing much better in their inflation targeting measures. Given this, we believe emerging markets and currencies are quite well prepared to accommodate the elevated pressure from a higher US dollar.

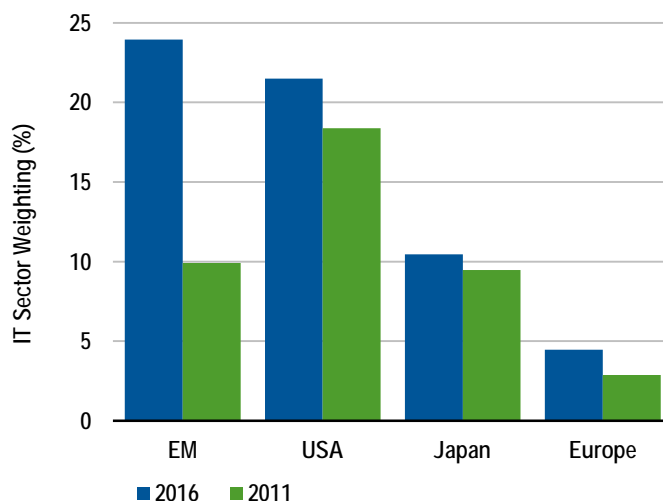
In assessing risk, we believe it remains important to focus on fundamentals to measure and assess vulnerabilities. One important measure is the amount of debt relative to Gross Domestic Product (GDP). Developed market debt-to-GDP ratios are usually somewhere at or above 100%. In contrast, emerging markets have, on average, about 40% debt-to-GDP in the public sector – it looks even better when you look at company balance sheets. As a stock picking house we prefer companies which have even more conservative balance sheets, which should mean lower risk.

Other positive indicators for emerging markets include:

- Overall risk as measured by interest rate spreads (the difference in interest rates between emerging and developed markets) is quite well under control.
- Local purchasing manager indices are showing an expectation that the local business environment is improving;
- Earnings have been under pressure, but we are seeing a mean reversion of earnings and we expect they will continue to improve throughout the next couple of quarters and that is not yet reflected in share prices.

The Growing Importance of Technology in Emerging Markets

2011 v 2016



For illustrative and discussion purposes only. EM = MSCI Emerging Markets Index. USA = MSCI USA Index. Japan = MSCI Japan Index, Europe = MSCI Europe Index. Source: MSCI, FactSet, as of September 2016.

I think what is important to understand that there are clear risks, but we believe these are, in some cases, overstated and emerging market countries have a larger toolkit than in previous crises.

How is TEMIT positioned to benefit from an improving environment for emerging markets?

Within TEMIT, there are two main themes I'd like to highlight. Firstly, we have reduced our exposure to Government influenced companies in Asia and some other markets and moved more towards private sector companies. Secondly, we have moved away from some of the more traditional bricks and mortar businesses in emerging markets towards technology-based companies which are at the forefront of innovation.

Private Sector Companies

We have a preference for pure private sector companies which preferably have no issues with regulation or dominant shareholders that would make our lives difficult. We like companies which are able to compete on costs and that have shown the flexibility and strength to adjust their business model even in difficult times. I think the recent period was a good test for some of those companies.

Technology

Our positioning in information technology is the single biggest change in TEMIT. We are seeing very competitive business models being developed out of emerging markets which cater to the technology sector. The scepticism we saw about a year ago allowed us to invest in companies which were punished for the wrong reasons and they have begun to have a very positive contribution to the performance of our portfolios.

Of course, as stockpickers I think we have to differentiate between technology companies. Some of these companies are loss making and running risky business models, but we focus more on the traditional ones within this space: companies which have solid balance sheets, proven business models and, which are able to pay out dividends to investors.

TEMIT Positioning - Sectors as at 31 October 2016

Sector	TEMIT	MSCI Emerging Markets Index
Information Technology	26.4	23.6
Consumer Discretionary	21.5	10.4
Financials	17.4	24.1
Consumer Staples	9.6	7.7
Materials	7.3	6.6
Energy	7.3	7.7
Industrials	3.8	5.9
Health Care	1.7	2.5
Real Estate	0.6	2.6
Telecommunication Services	0.5	6.0
Utilities	0.3	2.9

Weightings as percent of total including cash. Percentage may not equal 100% due to rounding. Information is historical and may not reflect current or future portfolio characteristics. All portfolio holdings are subject to change. Indices are unmanaged and one cannot invest directly in an index.

Just to give you some examples, we are focusing on those which are supplying components, such as the battery-driven automobiles specific to Asia. We are also focusing on other component producers which allow automobiles to be lighter in the future. That is a very big theme we are seeing. In addition we are looking at companies which produce things such as cameras and sensors for automobiles as well as in other areas such as DRAM and memory producers, which again are expected to benefit from the ever expanding demand for memory power. In today's world where fridges and microwaves begin to have memory, with the Internet of Things coming to fruition, we see that this is a space which is of a lot of interest and attraction.

Frontier Markets

We also moved, to some degree, into frontier markets to address the changes we are observing in the universe overall. Countries in Africa, and some of the smaller Asian and Latin American markets, are going through decent reform and producing the right results and give us the opportunity to invest in companies which are benefitting from large, very under-penetrated, domestic consumer societies.

Other Positions

Financials is one of the biggest reductions. We have a little bit of exposure to the Chinese insurance sector, but no exposure to Chinese banks. The financial sector is faced with a lot of disruptive new business models, regulatory pressure and still-declining margins overall, so we don't see that as an attractive sector to invest in. The other big reduction has been in energy. We have increased exposure slightly to consumer discretionary, adding a couple of companies within that sector, and consumer staples has also had a slight increase.

TEMIT Top 10 Holdings as at 31 October 2016

Issuer	Sector	Country	% of Total
Brilliance China Automotive	Consumer Discretionary	Hong Kong / China	6.0
Samsung Electronics	Information Technology	South Korea	5.8
Taiwan Semiconductor Manufacturing	Information Technology	Taiwan	4.6
Unilever	Consumer Staples	United Kingdom	3.9
Naspers, N	Consumer Discretionary	South Africa	3.9
Buenaventura, ADR	Materials	Peru	3.6
Itau Unibanco, ADR	Financials	Brazil	3.5
Tencent	Information Technology	Hong Kong / China	3.4
Astra International	Consumer Discretionary	Indonesia	3.2
MCB Bank	Financials	Pakistan	2.2
Total			40.1

The Ten Largest Holdings represent the ten largest holdings of TEMIT as at the date indicated. These securities do not represent all of the securities purchased, sold or recommended for clients, and the reader should not assume that investment in the securities listed was or will be profitable. All portfolio holdings are subject to change. Holdings of the same issuer have been combined.

Could you talk through some specific holdings?

If we talk about the top 10 holdings of TEMIT as at the end of October, first of all we have Brilliance China, the BMW joint venture partner in China. For BMW, China is the number one market in terms of importance and expansion activity. They have recently added capacity in China, and are now moving aggressively into products which are designed specifically for the Chinese consumer; a lot of the products that they are selling are only available in China. The company is also well positioned to benefit from the changes that are taking place in terms of the migration to battery-driven cars.

Brilliance China has a solid balance sheet, we think it is an undervalued and profitable business, with a great brand name, and is extremely popular – every Chinese person who is not driving a BMW would like to move up and buy one.

The shares have performed extremely well over the last couple of months, reflecting some of that strength. When there is pressure on the stock, it is normally related to China scepticism and slowdown in demand, but we see that as a short-term development and think the long-term potential of these automobile companies in China is still very high.

I talked about technology earlier; Samsung Electronics, which is the leader in memory development and also in OLED (the new screen technology for televisions and smartphones coming mainstream next year). They are very well positioned in consumer electronics. It is an extremely well-run company that is now looking to address some of the corporate governance issues with lots of money on the balance sheet, so they are looking into higher payout for shareholders. I also think the recent scandal about the Note 7 phone is also forcing them to address some of the concerns around corporate governance.

Buenaventura is one of the most cost competitive gold, silver, and copper miners in Latin America, and has more than doubled in the last year. We still think it is very competitive and getting along much better with local communities than some of the South African miners. Again, from a valuation standpoint, despite the fact that we have seen a good rally, we think that there is upside in the share price.

Tencent is the single largest online gaming company in China, with 900 million daily active users. They also control the largest and most popular app, equivalent to WhatsApp, called WeChat, but much more complex and much more interesting than WhatsApp. You can also do online banking – they have got Tenpay allowing you to do e-commerce and online shopping through their website, you can also buy insurance products. They are a real leader in the digital online business in China.

Finally, MCB Bank, the leading bank in Pakistan, is a good example of our move into frontier markets. They have been in the portfolio for quite some time. Pakistan is going to be upgraded from the MSCI Frontier Markets Index to the MSCI Emerging Markets Index next year, so fundamentally, we think there is still a very good environment there for banks in Pakistan, and valuations also meet our criteria.

Finally, could you share thoughts on China?

China is a complex topic with a lot of moving parts. As you can see from our positioning, we have stayed away from the very large Chinese companies like China Telecom and the Chinese banks, especially the largest index constituents. This reflects our view that there is still a lack of transparency with regards to the annual reports, the reporting standards.

We still think it is a concern that debt in China has reached sky-high levels, but as a mitigating factor the Chinese Government still has a lot of room to manoeuvre. If you look at the monetary and fiscal situation, they still are in good shape and can do a lot on the fiscal side to support the domestic economy.

I think the recent news regarding further attempts to control flow of capital is a reflection that there is not enough confidence in their own economy by domestic savers/entrepreneurs to keep their money in the country, so that is a rather bad sign. We expect that there is going to be a prolonged phase of pressure on the currency from here onwards.

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