Charlemagne Capital

Investing in Quality

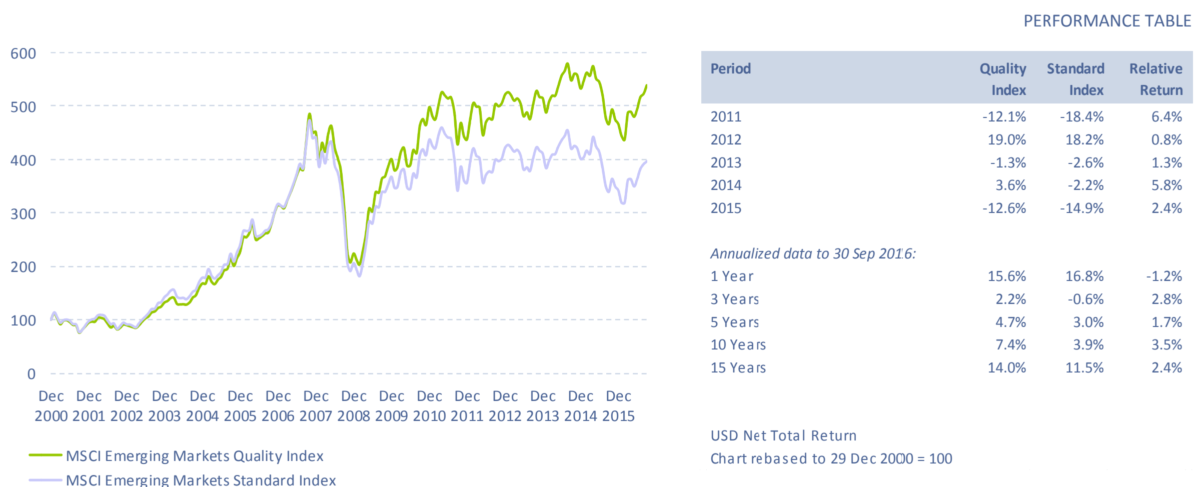
Our underlying principle

"We believe that by investing in quality companies, with high returns on capital, strong cashflow generation and effective management, we will generate superior long-term returns for our clients"

The market often 'over-discounts' the short term, paying too much attention to short-lived newsflow such as quarterly earnings or monthly sales figures, and 'under-discounts' the long term, giving too little notice to the power of compounding or the impact of structural change. The share prices of companies that may appear to be overvaled in the short term can thus still perform well over the long term. We believe that by investing in quality, we give our clients access to those companies whose businesses will outperform over the longer term. This analysis investigates whether quality investing has resulted in superior performance in emerging market equities over time.

Our findings go back over 15 years and includes a variety of market environments. It covers a timeframe from the end of the Western 'bubble economy' and the commodity super-cycle, in which emerging market equities performed strongly, to the global financial crisis and the gradual recovery in the West, which coincided with a period of underperformance for emerging market equities, subsequently reversed.

First, we look at the performance of the MSCI Emerging Markets Quality Index compared to the standard MSCI Emerging Markets Index. The MSCI Emerging Markets Quality Index aims to capture the performance of quality growth stocks by identifying stocks with high quality scores based on three main fundamental variables: high return on equity (ROE), stable year-over-year earnings growth and low financial leverage.



PERFORMANCE TABLE

Period	Quality Index	Standard Index	Relative Return
2011	-12.1%	-18.4%	6.4%
2012	19.0%	18.2%	0.8%
2013	-1.3%	-2.6%	1.3%
2014	3.6%	-2.2%	5.8%
2015	-12.6%	-14.9%	2.4%
Annualized data to 30 Sep 2016:			
1 Year	15.6%	16.8%	-1.2%
3 Years	2.2%	-0.6%	2.8%
5 Years	4.7%	3.0%	1.7%
10 Years	7.4%	3.9%	3.5%
15 Years	14.0%	11.5%	2.4%

USD Net Total Return
Chart rebased to 29 Dec 2000 = 100

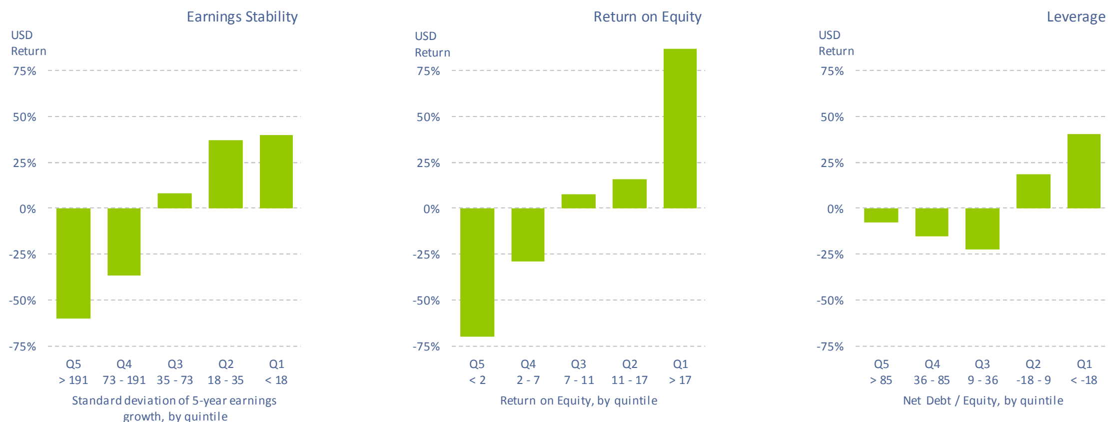
Source: MSCI

It is evident that the quality index has indeed outperformed the standard index over time, even if for shorter periods it may underperform.

We now investigate whether this outperformance is due to the dominance of any one particular fundamental variable or whether each of these quality factors contribute in equal measure. We look at the performance of each of these variables separately since 30 Apr 2008 (the earliest data we have available).

Specialists in emerging markets

This is shown in the charts below. In modelling earnings stability we have excluded companies with falling earnings, on the common sense reason that a company with volatile but positive earnings growth is more likely to be a more attractive proposition over a seven-year time horizon than one with consistent but declining earnings over the same timeframe.



Performance of MSCI Emerging Markets Index from 30 Apr 2008 to 30 Sep 2016, USD net total returns. Source: FactSet, MSCI

The MSCI Quality Indexes are designed to reflect a quality growth investment strategy by identifying stocks with historically high return on equity, stable year-over-year earnings growth, and low financial leverage. Source: MSCI

Our findings support the thesis that each fundamental variable or factor – earnings stability, return on equity and leverage – have separately resulted in outperformance over the studied period of more than eight years. We can therefore conclude that the outperformance of the MSCI Emerging Markets Quality Index and, more broadly, the superior returns generated by investing in quality companies, is due to each of the key factors above and not because of one particular, dominant factor.

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November 2016

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