Emerging Markets for the Long Haul

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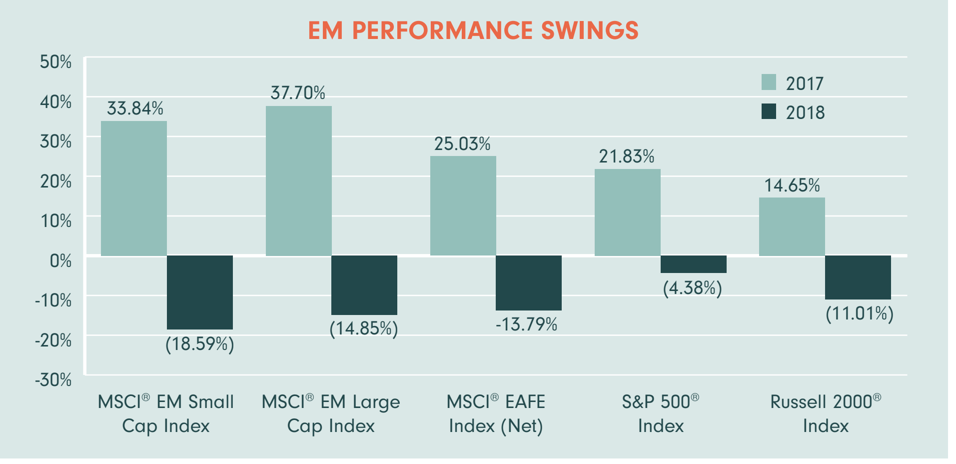
Investment Management

EMERGING–MARKET EQUITIES WERE ONE OF THE MOST VOLATILE ASSET CLASSES IN 2018 as headwinds such as tariff concerns, a rising U.S. dollar and political uncertainty contributed to severe losses. But long-term investors should know that the volatile and sometimes outsized swings in performance are quite the norm when it comes to emerging markets, and that the asset class—particularly the small-cap segment—can be a long-term winner and an important component of a well-diversified portfolio thanks to its improving fundamentals and potential for outperformance.

EM in 2018 - What Happened and Why?

Emerging-market stocks posted an impressive absolute and relative performance in 2017, with the MSCI EM (Emerging Markets) Small Cap Index gaining 33.84% and the MSCI EM (Emerging Markets) Large Cap Index up 37.70%—versus 25.03% by the MSCI EAFE Index, 21.83% by the S&P 500 Index, and 14.65% by the Russell 2000 Index. Not long after, however, emerging-market stocks about-faced, with the small-cap index falling 18.59% and the large-cap index falling 14.85% in 2018.

The decline in emerging-market stocks throughout 2018 is a result of a combination of factors playing out globally, which we discuss in detail below.



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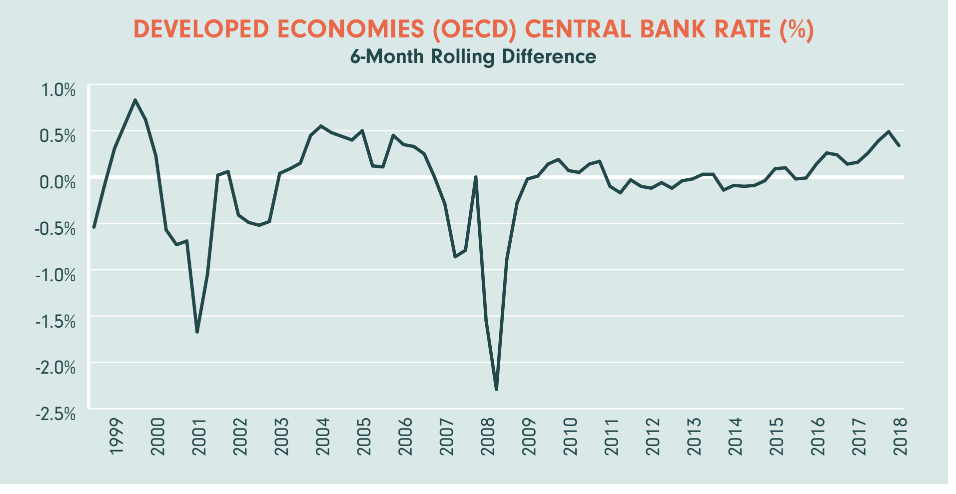
1. Global liquidity:

Central banks around the world have been tightening their monetary policy by raising interest-rates, draining the liquidity available globally at a faster clip. The graph to the right charts the 6-month rolling differences in the central-bank rates of developed economies tracked by Bloomberg. The December 2018 figure is at levels not seen since before the Great Recession.

Emerging-market economies saw growing amounts of capital flowing in as investors chased higher yields in those regions in the years of low interest-rates in the U.S. and elsewhere. The drying up of global liquidity, and particularly U.S. dollar liquidity, is likely to present a headwind for those emerging-market economies, which generally have been on the receiving end of monetary-policy tightening.



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2. Strength of the U.S. dollar:

The U.S. dollar strengthened steadily in 2018, putting pressure particularly on emerging-market currencies. The DXY Index, which measures the U.S. dollar against a basket of major world currencies, rose 4.40% in 2018. U.S. dollar strength is caused by various factors, including a stronger economy relative to those of other countries. Trade rhetoric, particularly the ongoing conflict with China, also has driven investors to flock to the dollar as a safe-haven asset. A continued dollar rally could exacerbate vulnerabilities in emerging markets, which will feel pressure as servicing dollar-based commodities and debt becomes more expensive.

3. Country-specific risks:

Turkey saw its lira plunge in value through the year, losing 34% of its value against the dollar since January into August, while recovering slightly in recent months. Currency depreciation helped fuel inflationary pressure—consumer price growth hit 25% in October—and the stock market also suffered, losing 20.86% over 2018. Factors contributing to an economic decline in Turkey are concerns that Turkish companies that borrowed heavily may struggle to repay loans in dollars; worsening relations with the U.S. administration with sanctions and tariffs; and concern over central-bank independence from President Recep Tayyip Erdogan's efforts to lower borrowing costs.

Argentina's peso also experienced a run in 2018, plunging against the dollar by more than 50% through September and gaining back some ground later in the year. The primary causes were investor concern on the government's ability to deal with its budget deficit and to control inflation, as well as the strengthening U.S. dollar. Argentina's central bank in September received $50 billion in a bailout fund from the International Monetary Fund.

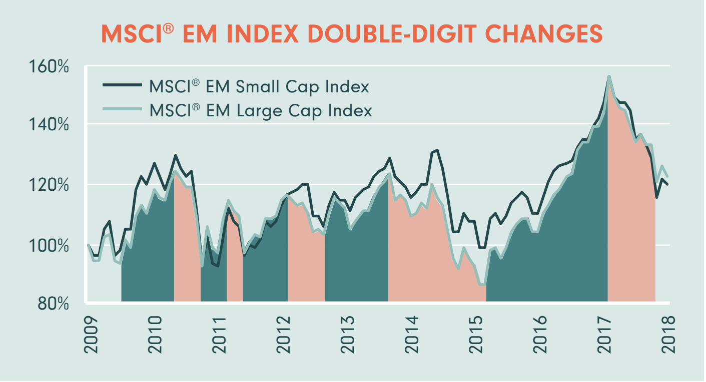
4. China and trade-tariff friction:

China's growth is slowing by a number of measures. The country's GDP grew 6.9% year over year in 2017 and 6.6% in 2018, the slowest pace in 28 years. The slowdown is expected to continue, with the 2019 expansion rate forecast at 6.2%. Stricter financial regulation and a general tightening of financial conditions due to higher rates globally have combined to create a less favorable economic backdrop for the country, with investments and confidence falling, evidenced in part by generally cooling industrial production and retail sales. The world's largest exporter also has seen foreign sales threatened as the trade spat with the Trump administration continues.

Long-Term Story Still Stands

Despite the various near-term challenges experienced by emerging markets, the long-term case for the asset class remains intact.

For one, historical data show that steep losses in emerging-market stocks are often followed by swift recoveries. The following graph shows both the small- and large-cap emerging-market indices. The shaded areas represent periods of double-digit gains and falls exhibited by the large-cap index. It is clear that the small-cap index closely tracks—usually slightly above—the large-cap index.



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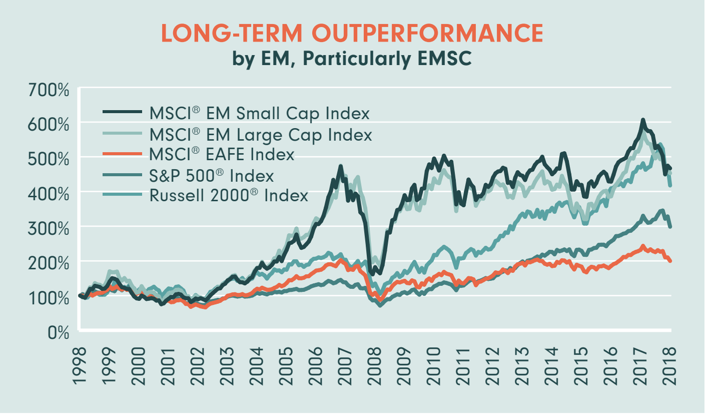
Dips and recoveries are part of a normal pattern for emerging-market equities. There is nothing unusual about episodic drawdowns, as unwelcome as they are, amid what has proven to be longer-term outperformance versus developed-market assets.



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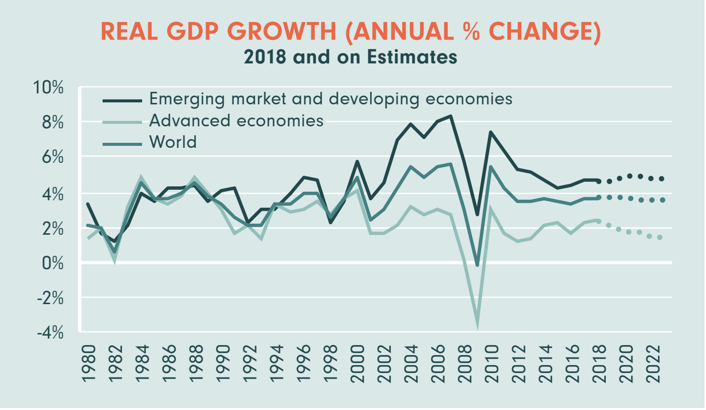
Growth in emerging markets is expected to outpace that of advanced economies and the world overall. The IMF pegs annual real growth of emerging-market and developing economies at 4.7% for 2018 and generally headed up in the future, versus 2.4% for 2018 and a slowing down for advanced economies:



Data accessed November 18. 2018. Data is obtained from the International Monetary Fund and is assumed to be reliable. Past performance is no guarantee of future results.

Furthermore, the trend of middle-class growth is favorable for emerging economies. One study[1] estimates the growth rate at about 6%, describing it as "far more dynamic" than for advanced economies, for which it projects middle-class growth at between 0.5% and 1% a year.

Macro factors could also change. The U.S. dollar rally could subside, and interest-rate increases could slow. And in January 2019 the Fed suggested it may further lower its rate-hike forecast if necessary. The Federal Reserve raised rates in December but lowered its forecast for 2019, to two hikes from three raises previously projected. And in January 2019 the Fed suggested it may further lower its rate-hike forecast if necessary. Emerging markets themselves could start to raise rates, and the country-specific issues are largely that—brought on by each country's own set of circumstances and are not necessarily representative of a regional slowdown. Further, tariff issues, though uncertainties remain, could go on for only so long.

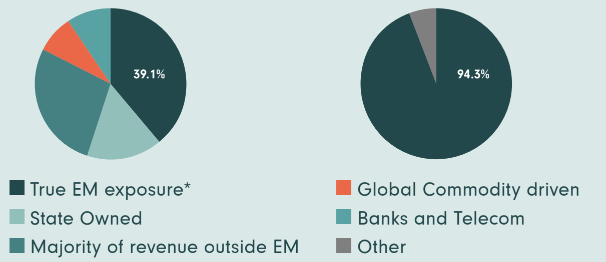
In sum, the long-term story supporting emerging markets has been in place for decades and should continue given that structural and fundamental trends look to be moving in the right direction. Emerging-market equities merit consideration as a key component of a well-diversified portfolio, as they can benefit from the current positive developments in credit fundamentals, strong demographic trends and higher growth potential that are characteristic of emerging markets.

KAR Emerging Markets Small Cap

Within this fundamental framework of a positive outlook within emerging markets broadly, Kayne Anderson Rudnick takes a focused, active approach, specifically in the small-cap segment. The conviction behind this approach is largely twofold: We believe active management allows for skilled managers to better leverage the advantageous characteristics of emerging markets while steering clear of issues that are likely to pressure broader indices tracking emerging-market stocks. And we believe a focus on small caps allows us to capture "true" emerging-market exposure, as the large-cap segment exhibits higher concentration of state-owned companies and consists of highly regulated industries and companies that make the majority of their revenues outside of emerging markets. The small-cap space provides exposure to sectors and businesses that are more closely aligned to secular growth trends within the countries.

SMALL CAPS BETTER CAPTURE THE GROWTH IN EMERGING MARKETS

Composition of EM Large Cap (Largest 20 Holdings) | **Composition of KAR EM Small Cap (Largest 20 Holdings)**



**True EM exposure is defined as businesses that generate the majority of revenue and cash flow in EM. Data presented is for the period ending December 31, 2018. Data is obtained from FactSet Research Systems and is assumed to be reliable. Past performance is no guarantee of future results.*

It is worth noting that the emerging-market small-cap group has a better return and risk profile:

	ANNUALIZED RETURN	ANNUALIZED STANDARD DEVIATION	BETA
MSCI® EM Small Cap Index	8.01	22.11	0.93
MSCI® EM Large Cap Index	7.84	22.29	1.00

Data presented is based on monthly returns from January 1, 1999 through December 31, 2018. Data is obtained from FactSet Research Systems and is assumed to be reliable. Past performance is no guarantee of future results. EM Large Cap represented by the MSCI Emerging Markets Index.

The small-cap segment also is larger than one might expect and less efficient in terms of analyst coverage, which provides for a relatively untapped market where skilled active investors can identify high-quality stocks at attractive prices.

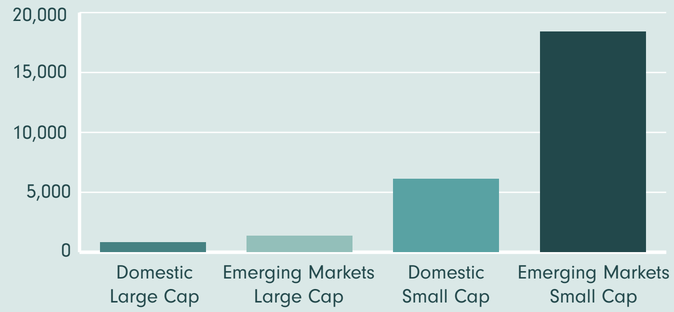
ANALYST COVERAGE

Average Number of Analysts Covering Individual Stocks

Data presented is as of February 4, 2019. Data is obtained from FactSet Research Systems and is assumed to be reliable. Past performance is no guarantee of future results.

INVESTABLE UNIVERSE

Number of Companies



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1. *"The Unprecedented Expansion of the Global Middle Class" by Homi Kharas, the Brookings Institution, February 2017, the latest update available.*

KAR's emerging-markets team monitors for companies with quality characteristics: high return on capital over a full economic cycle, long and resilient earnings history and minimal debt are key metrics. We look for competitive protection, capital efficiency, growth prospects and solid corporate governance, among other factors. The KAR Emerging Markets Small Cap Portfolio had the following fundamental characteristics and performance in comparison to its benchmark:

	RETURN ON EQUITY - PAST 5 YEARS	TOTAL DEBT/ EBITDA	INTEREST EXPENSE COVERAGE	EARNINGS PER SHARE GROWTH- PAST 5 YEARS	EARNING PER SHARE GROWTH- PAST 10 YEARS
KAR Emerging Markets Small Cap	21.3%	0.8x	6.8x	17.2%	10.5%
MSCI® Emerging Market Small Cap Index	11.3%	4.2x	2.5x	9.4%	8.7%

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	KAR EMERGING MARKETS SMALL CAP GROSS (%)	KAR EMERGING MARKETS SMALL CAP NET (%)	MSCI® EMERGING MARKETS SMALL CAP INDEX (%)	EXCESS RETURN (BPS)
4Q 2018	(5.54)	(5.78)	(7.18)	163
1 Year	(3.86)	(4.82)	(18.59)	1473
3 Years	14.90	13.76	3.68	1122
Since Inception*	5.42	4.37	0.95	446

**January 1, 2014*
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We believe our strict focus on high-quality companies, rigorous research and the degree of conviction we assign to each individual business we own combine to support consistent outperformance of the strategy over the long term.

This report is based on the assumptions and analysis made and believed to be reasonable by Advisor. However, no assurance can be given that Advisor's opinions or expectations will be correct. This report is intended for informational purposes only and should not be considered a recommendation or solicitation to purchase securities. Past performance is no guarantee of future results.

DISCLOSURE

Kayne Anderson Rudnick Investment Management, LLC claims compliance with the Global Investment Performance Standards (GIPS®) and has prepared and presented this report in compliance with the GIPS® standards. Kayne Anderson Rudnick Investment Management, LLC has been independently verified for the period from January 1, 1999 through December 31, 2017. The verification reports are available upon request.

Verification assesses whether (1) the firm has complied with all the composite construction requirements of the GIPS® standards on a firm-wide basis and (2) the firm's policies and procedures are designed to calculate and present performance in compliance with the GIPS® standards. Verification does not ensure the accuracy of any specific composite presentation.

Kayne Anderson Rudnick Investment Management, LLC, a wholly owned subsidiary of Virtus Investment Partners, Inc., is a registered investment advisor under the Investment Advisers Act of 1940. Registration of an Investment Advisor does not imply any level of skill or training. Kayne Anderson Rudnick Investment Management, LLC manages a variety of equity and fixed-income strategies focusing exclusively on securities the firm defines as high quality.

The composite includes all fully discretionary institutional and pooled Emerging Markets Small Cap Portfolios. Emerging Markets Small Cap Portfolios are invested in equity securities with market capitalizations in line with the MSCI® Emerging Markets Small Cap Index, that have market control, rising free cash flow, shareholder-oriented management, strong consistent profit growth and low-debt balance sheets. For comparison purposes, the composite is measured against the MSCI® Emerging Markets Small Cap Index (net). The MSCI® Emerging Markets Small Cap Index is a market capitalization-weighted index of small-capitalization stocks from countries defined as Emerging Markets in the MSCI® Global Investable Market Indices Universe, excluding U.S. companies. The index is calculated on a total-return basis with dividends reinvested, net of withholding taxes. Benchmark returns are not covered by the report of the independent verifiers. The composite was created in January 2014. A list of composite descriptions and policies for valuing portfolios, calculating performance and preparing compliant presentations are available upon request.

The standard management fee schedule currently in effect is as follows: 1.00% for the first $100 million; 0.90% on the balance. Actual management fees charged may vary depending on applicable fee schedules and portfolio size, among other things. Additional information may be found in Part 2A of Form ADV, which is available on request. The performance information is supplied for reference. Past performance is no guarantee of future results. Results will vary among accounts. The U.S. dollar is the currency used to express performance. Returns are presented gross of withholding taxes and net of transaction fees and include the reinvestment of all income. Gross returns will be reduced by investment management fees and other expenses that may be incurred in the management of the account. Model net returns have been calculated by deducting 1/12th of the highest tier of the standard management fee schedule in effect for the respective period from the gross composite returns on a monthly basis.

Internal dispersion is calculated using the asset-weighted standard deviation of annual gross returns for accounts in the composite for the entire year. For those years when less than five accounts were included for the full year, no dispersion measure is presented. The three-year annualized ex-post standard deviation, which measures the variability of the composite (using gross returns) and the benchmark for the 36-month period, is not presented for periods prior to 2016 because 36 monthly composite returns are not available.

3-Yr Annualized Standard Deviation (%)

December 31	Composite	Benchmark
2016	15.00	14.54
2017	14.07	14.57

Year	Total Firm Assets ($ Millions)	Total Composite Assets ($ Millions)	Accounts at Year End	Gross Annual Return (%)	Net Annual Return (%)	MSCI® Emerging Markets Small Cap Index (net) Annual Return (%)	Internal Dispersion
2014	7,989	5	< 5	2.20	1.16	1.01	n/a
2015	8,095	4	< 5	(16.02)	(16.84)	(6.85)	n/a
2016	9,989	5	< 5	18.45	17.28	2.28	n/a
2017	14,609	14	< 5	33.20	31.90	33.84	n/a

The MSCI® Emerging Markets Small Cap Index is a trademark/service mark of MSCI®. MSCI® is a trademark of MSCI Inc.

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