EMERGING MARKETS

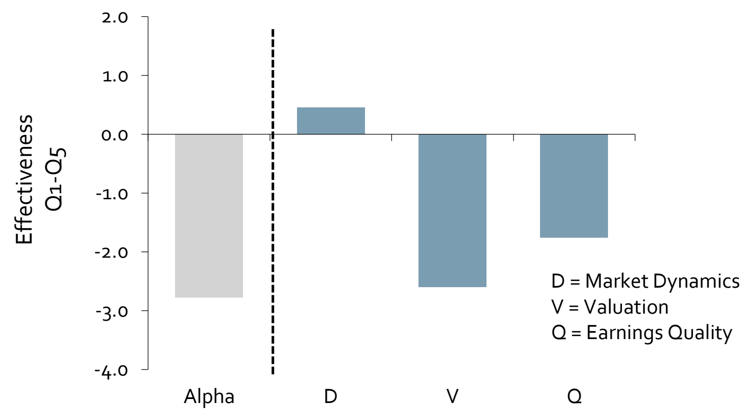
Q2 2020 COMMENTARY

INVESTMENT RESULTS & ATTRIBUTION

The LMCG Emerging Market Strategy returned +15.0% versus +18.1% for the MSCI Emerging Market Index during the second quarter. Since its January 1, 2008 inception, the strategy has returned an annualized +1.5% versus +0.6% for the MSCI Emerging Market Index.

The LMCG Emerging Markets Strategy fell short of its benchmark this quarter as the COVID-19 crisis intensified and factor volatility remained elevated. Performance for the strategy was consistent with results for the overall stock selection model (*Alpha*). See Figure 1. *Market Dynamics* (D), which contains *Price Momentum* and *Analyst Revision*, was the strongest of the three composite factors while *Value* and *Quality* both produced negative results. On average, the investing environment reversed from last quarter and was substantially more risk-on as economic indicators showed signs of improvement. Generally, when investors embrace risk, cheap (*Value*) stocks do well as they are considered riskier. However, this quarter we observed that cheap stocks continued to underperform while stocks with other risky attributes such as high beta and higher default risk did well. *Market Dynamics* worked on average but was largely driven by strong results in June. *Quality* was mixed from month to month.

FIGURE 1: FACTOR PERFORMANCE



Source: LMCG

Overall, stock selection within countries was negative for the quarter, led by selections in China, India and Brazil. The best stock selection was in Taiwan and Malaysia. Country allocation added modestly to performance led by an overweight in Korea and underweight positions in China and Saudi Arabia. Within sectors, stock selection was also negative primarily due to selection in Consumer Staples and Energy. The best stock selection was in Utilities. Sector allocation resulted in a slight positive contribution to performance led by underweight positions in Financials and Consumer Staples. Given the strong equity market performance, our small cash balance contributed negatively to performance.

MARKET REVIEW

Global markets bounced back during the quarter, retracing a portion of their losses from the previous quarter. Emerging market large caps performed well, outperforming their developed market peers but falling short of their U.S. peers. The MSCI Emerging Market Index returned 18.1% versus 21.8% for the Russell 1000 and 14.9% for the MSCI EAFE Index. Despite positive returns on average, markets continued to be volatile as investors focused on news related to treatment and containment of the virus and global economic recovery.

Last quarter we discussed the potential for the value style to outperform given the wide valuation spreads we observed in emerging markets as well as in the U.S. and developed markets. Historically, wide Valuation spreads have indicated that the Value style is likely to perform well in the near future. Valuation spreads, which are a measure of the difference between the cheapest and the most expensive stocks in a stock universe, widened considerably during the first three months. Cheap stocks underperformed as investors fled riskier stocks in the uncertain environment and continued to pile into growth stocks which had been performing well and had good Price Momentum. Stocks with more defensive qualities such as low beta also continued to do well. Going into the second quarter, we believed the environment would reverse as markets stabilized and subsequently bounced back. In Figure 2 below we show the Quintile 1- Quintile 5 Excess Return for Value, Momentum and BARRA's measure of Beta. We compare how these factors worked for the MSCI EM, MSCI EAFE and Russell 1000 universes for the first and second quarters. In the first quarter, the factors performed fairly similarly across the different universes.

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Value experienced negative payoffs across the board while Momentum was positive. In both cases, the payoffs in the U.S. were stronger than what we observed in either the MSCI EM or MSCI EAFE universes. BARRA Beta was also quite negative but the payoffs were more consistent. In the second quarter, as economic data started to trickle out and the news was a bit more optimistic, investors began to embrace riskier stocks. We see this in the positive performance for BARRA beta across the three indexes but again it was stronger in the U.S. at +6.24 for the Russell 1000 versus +2.92 for the MSCI-EM Index. Given the wide valuation spreads and the risk-on environment, we also expected to see a strong payoff to Value. However, Value stocks continued to suffer, particularly in emerging markets and developed markets. They showed some signs of life in the U.S. with an average payoff for the quarter of 0.81 but it was hardly the reversal we were expecting after the crushing -7.75 payoff in the previous quarter. In contrast, Price Momentum tends to be less effective in risk-on periods and more effective in risk-off periods such as the first quarter. During the first quarter, Momentum behaved as we would expect and worked very well across all three indexes. In the second quarter, Momentum did reverse but again it was much stronger in the U.S. at -3.61 versus -0.22 for the MSCI EM index.

FIGURE 2: QUINTILE 1 – QUINTILE 5 EXCESS RETURN FOR VALUE, MOMENTUM, AND BARRA BETA COMPARING Q1 2020 TO Q2 2020

	Value			Momentum			BARRA Beta		
	MSCI EM	MSCI EAFE	Russell 1000	MSCI EM	MSCI EAFE	Russell 1000	MSCI EM	MSCI EAFE	Russell 1000
Q1-2020	-4.67	-5.82	-7.75	2.64	1.91	3.85	-4.36	-5.31	-5.37
Q2-2020	-2.59	-1.59	0.81	-0.22	0.37	-3.61	2.92	1.82	6.24

Source: LMCG

We looked back at previous crises such as the Tech and Telecom bust in 2001 and the Global Financial Crisis in 2008 and 2009 to see if we could gain some insights into how factors behaved during those periods. In the first quarter when markets panicked due to the economic fallout from the Coronavirus, factor performance was similar to what we observed in the initial downturn for both of those crises. However, in the second quarter, as markets recovered, higher beta stocks did outperform as we expected, but the payoffs to Value and Momentum were less consistent with what we observed in the past.

OUTLOOK

This quarter saw a tremendous rebound in equities around the world. However, a great deal of uncertainty remains as to how companies can operate their businesses in this new normal with constantly changing safety protocols. There are also threats to country re-openings as they fight to contain the virus and prevent outbreaks. We believe the crisis and economic recovery will continue to unfold over the next several months. As we work through this quarterly earnings cycle and companies start to provide some guidance for the rest of the year, we would expect factor performance to continue to be volatile. As investors are able to see through the crisis, we expect factor performance to stabilize which would bode well for the strategy. We would also anticipate a more sustained risk-on rally which should favor *Value* over *Price Momentum*.

STRATEGY

Our investment philosophy is based on a bottom-up quantitative approach to investing. We believe inefficiencies in the market create opportunities and a quantitative process is well-suited to capture these inefficiencies and outperform. Our stock selection model groups factors into three major categories: *Market Dynamics*, *Value* and *Quality*. Our *Market Dynamic* factors are designed to exploit short-term trends as we believe investors under react in the short term. Our *Value* factors are intended to capture mean reversion as investors tend to overreact in the longer term. Our *Quality* factors incorporate information about the quality of earnings that investors tend to overlook. Over time, we believe this style of management will generate positive relative returns.

LMCG INVESTMENTS