Summer 2018

Investment opportunities: A look at the emerging markets consumer sector

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Emerging markets (EM) equity sectors are as diverse as the countries themselves. The attributes that drive performance in, say, an Indian pharmaceutical company have little connection to what affects a Russian oil conglomerate. Perhaps nowhere is this diversity more evident than in the consumer-related sectors of emerging markets, which are exploding with opportunity—if investors know how to differentiate among the possible winners and losers.

Key points

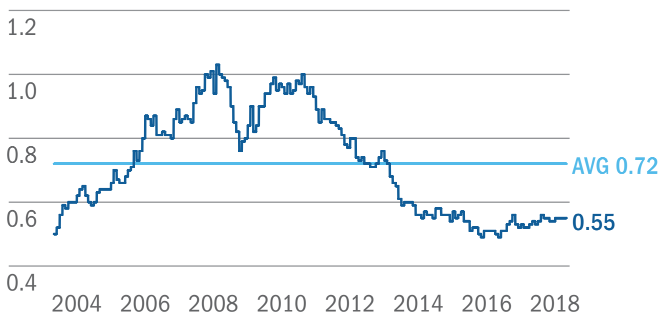
- Despite impressive performance in 2017, we believe emerging markets equities remain attractively valued.
- Many emerging economies are at a critical inflection point for consumer spending, which could drive strong levels of future economic growth.
- Emerging markets consumer companies appear fundamentally attractive and tend to have low correlations to the broader market.
- We believe investments in these areas require close scrutiny, which makes a case for active management.

Emerging markets: A world of opportunity

The MSCI Emerging Markets Index was up an impressive 37.3% in 2017, handily outpacing nearly all developed markets, most of which experienced returns in the 20% to 25% range. In our opinion, many of the factors that drove this strong performance are still in place—robust economic growth, low inflation and good corporate earnings growth prospects. Notably, despite 2017's superior returns—the best year for the index since 2009—valuations remain attractive.

Exhibit 1: Emerging markets remain attractively valued

Price-to-book value versus U.S. equities



Source: Bloomberg. June 2003-June 2018. Data reflects the price-to-book value of the MSCI Emerging Markets Index versus the MSCI USA Index. A lower reading represents more attractive valuations for emerging markets equities.

Importantly, emerging markets are not monolithic. Instead, they enjoy immense diversity: The current universe includes 24 different countries, three distinct regions, 11 industry sectors and about 1,000 investable companies with a wide set of performance drivers. These numbers don't even include the so-called "frontier" markets such as Sri Lanka, Saudi Arabia and Argentina.

In our view, the degree of variation within the EM universe favors an active management approach that is able to identify compelling investment themes and opportunities across disparate markets. A prime example can be found in the massive disruption occurring throughout the consumer sector in these markets.

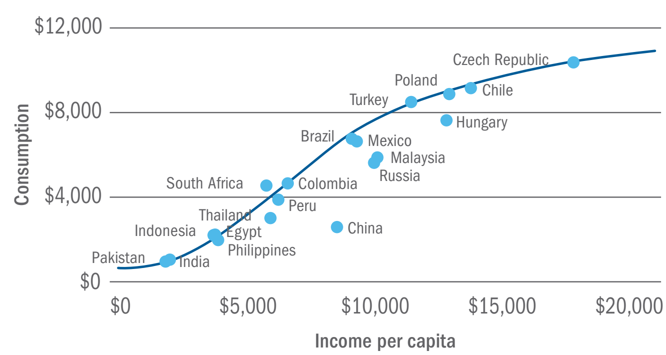
Consumption levels: A sweet spot for emerging markets

Consumption trends tend to vary widely depending on a country's economic development. In the early stages, consumers generally have little to no disposable income, meaning they spend nearly all of their money on the basics of food, housing and medical care. As economic growth increases at both the consumer and country level, however, people are able to allocate more money to discretionary spending. Then, when countries begin to develop a middle class, these consumption trends accelerate at both the individual and aggregate levels. Finally, in wealthy developed markets, consumers start to save more, with a smaller percentage of income spent on discretionary items.

An effective way to map these shifts is by analyzing what we call the "consumption S-curve," which compares absolute household consumption per capita to gross national income per capita.

Exhibit 2: Emerging economies are poised for a jump in spending

Consumption levels versus gross national income per capita



Source: World Bank, World Development Indicators as of 2016

The S-curve illustrates that consumption levels tend to accelerate once gross national income (GNI) per capita moves above the $5,000 level and trail off once it reaches somewhere around $8,000 to $10,000.

The good news for EM investors is that the majority of EM countries are within the steep part at the front end of the S-curve. Moreover, in many emerging markets, demographic trends help accelerate the effects of the curve. In particular, EM populations often skew much younger than their developed market counterparts, and as children and teens in EM societies age, the countries in which they live experience growth in GNI per capita—a further stimulant on the S-curve.

While all areas of an EM economy generally benefit from these consumption trends, we believe the consumer sector stands to gain the most. In our view, the current S-curve trend should provide a meaningful tailwind for the EM consumer sector for some time.

Emerging markets consumer sector: Fundamental opportunities

In addition to favorable demographics, positive industry- and company-specific characteristics make the EM consumer sector compelling. On balance, they offer many of the advantages investors look for when evaluating and selecting companies based on fundamental criteria.

These include:

- Attractive valuations
- Solid levels of free cash flow
- Focused business models
- Predictable drivers of success
- Relatively limited government influence
- Clear competitive advantages

Consumer companies are driven more by independent variables, favoring active management

The consumer sector is also the most diverse in the EM universe, with companies less likely to move in lockstep than those in areas like energy or materials. For example, if the price of oil drops, most, if not all, EM energy companies would likely be negatively affected. Given its diversity and lower correlations between and among subsectors, the consumer sector tends to be less susceptible to changes in broad macro variables.

The accompanying table compares the cross-correlation of returns within sectors—i.e., the extent to which individual stocks in a sector move in unison—as well as correlations between sectors and the broader market. (The table uses the 25 largest companies in the eight largest sectors within the MSCI Emerging Markets Index as a proxy for the sector as a whole.) The first row shows the percentage of companies within each sector that have correlations greater than 0.35 with each other. Companies in the financials and energy sectors tend to be affected by the same broad macro variables, and thus are prone to having higher correlations. The consumer sector, in contrast, features companies driven more by independent fundamental factors. In fact, less than 5% of consumer companies have cross-correlations higher than 0.35.

Exhibit 3: Companies in the EM consumer sector tend not to be highly correlated with each other or the broader EM index

	Consumer Top 25	Telecom Top 25	Industrial Top 25	Utilities Top 25	IT Top 25	Materials Top 25	Financials Top 25	Energy Top 25
Percentage of companies with more than 0.35 cross correlation	4%	6%	10%	12%	15%	21%	30%	40%
Percentage of companies with more than 0.35 correlation with the index	36%	40%	64%	64%	60%	84%	96%	88%

Source: Bloomberg. Data based on weekly correlations from 2012-2017.

The second row in the table makes this same point in a different way: By looking at the percentage of companies within each sector whose correlations exceed 0.35 with the EM index as a whole. In most sectors, 60% and more of companies have these relatively high correlations to the index, with financials the highest at 96%. Meanwhile, the consumer sector is by far the lowest, at only 36%.

In our view, the relatively low correlations within and among EM sectors make a strong argument for active management in this asset class—especially in the dynamic consumer sector—as individual companies perform so differently.

Identifying specific investments

So how might investors capitalize on EM consumption trends and these relatively low correlations?

As experienced EM equity investors, we have a distinct perspective on what's important in a consumer company and what's likely to drive its success. In addition, our investment process allows us to readily identify potential catalysts for EM company outperformance. One such catalyst is an effective management team that is able to learn from both the mistakes and successes of companies in developed markets.

A notable example of this can be found in traditional retailers. Consider where developed markets were about 20 years ago, when the Internet revolution was in its early stages. Many traditional brick-and-mortar retailers essentially ignored companies like Amazon that were quietly revolutionizing everything from logistics, inventory practices, customer service and financial transactions. These retailers were caught flat-footed when consumers came to expect a more "Amazon-like" experience from all of their interactions.

That same sort of mistake isn't being repeated widely by retailers in emerging markets. Internet penetration in some EM countries remains very low, especially in Latin America and Russia. That makes it hard for a pure online retailer to gain traction. The difference, though, is that many EM retailers have an exceptionally well-developed digital strategy as part of their core operations. In a country like Brazil, for example, some of the biggest e-commerce leaders are actually traditional offline retailers.

China is the key exception to this trend, as its online consumer business developed in much the same way it did in the United States. In EM countries outside of China, however, we are seeing massive integration between offline and online retailers—highlighting an area where investors might look to identify consumer companies with strong competitive advantages.

The convergence of traditional and online retailers is but one example of consumer-related trends that are driving emerging markets and that can have the potential to create investment opportunities. Since we mentioned China as an outlier to this specific trend, it is worth pointing out that investors in emerging markets need to pay close attention to developments within that country, since China tends to have a sizeable influence on many global consumer-oriented companies. Several luxury goods companies, for example, report half or even more of their sales come from China. Additionally, Chinese citizens are traveling abroad at an increasingly fast pace, which affects the performance of travel and leisure companies such as airlines, hotels, amusement parks, casinos and a wide range of consumer goods companies.

Finding investment opportunities

Emerging markets equities can be volatile at times, but we remain convinced that their attractive valuations, varied performance drivers and long-term return potential can make them an appropriate allocation within a diversified portfolio. Moreover, favorable demographics and the changing nature of EM consumers offer a particularly compelling case for investing in this asset class—provided, of course, that you know where to look.

For more information, visit us at TIAA.org

Definitions

The **MSCI Emerging Markets Index** is a free-float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. The **MSCI USA Index** is a free-float-adjusted market capitalization index that is designed to measure the large cap and mid cap segments of the U.S. stock market. The **price-to-book ratio (P/B ratio)** is a ratio used to compare a stock's market value to its book value. It is calculated by dividing the current closing price of the stock by the latest quarter's book value per share. A lower P/B ratio could mean that the stock is undervalued. **Correlation** is a statistical measure of how two securities move in relation to each other. Perfect positive correlation (a correlation coefficient of +1) implies that as one security moves the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation (a correlation coefficient of -1) means that securities will move by an equal amount in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; their movements in relation to one another are completely random.

You cannot invest directly in any index. Index returns do not reflect a deduction for fees or expenses.

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