FRANKLIN TEMPLETON

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Templeton Emerging Markets Investment Trust (TEMIT) Update

We recognise the importance of keeping investors updated on how we are managing assets during these exceptionally challenging times. To this end, we offered shareholders the opportunity to hear directly from Portfolio Manager, Andrew Ness and Nicole Vettise, IPM both from the Franklin Templeton Emerging Markets Group about how TEMIT is being impacted by the coronavirus outbreak and recent market volatility.

Welcome to this special TEMIT update webcast. My name is Nicole Vettise. I'm an Institutional Portfolio Manager in the Emerging Markets Equity Team, and it's my pleasure today to welcome Andrew Ness, who is the co-Manager of TEMIT.

During these challenging times, we felt it is very important, that we're fully connected with our shareholders and ensure that you have the opportunity to understand how TEMIT is being impacted by the coronavirus outbreak, as well as to ask your most pressing questions. Hence, why we've organised this call, and so Andrew is going to provide us with an update on TEMIT in the face of the coronavirus, but we will have some opportunity at the end to address any of your questions, so please do submit them online.

So, without further ado, let me hand over to Andrew.

I'm Andrew Ness, co-manager of TEMIT. Thank you for joining us today for this update call.

I'd like to start by saying that I hope you and your families are keeping safe and managing to cope with this extremely challenging situation that we find ourselves in. These really are unprecedented times. However, as I keep saying to my own family, if we're sensible, follow the official advice given, then at some point we will emerge from this period so let's not get overwhelmed by the fear and uncertainty. This too shall pass.

The purpose of today's call is to give you an update on what is happening in the emerging markets, how we are operating as a team, how TEMITs holdings are being impacted and what we've been doing in recent weeks.

Experienced in Managing Market Volatility

Before we do that, just a little bit of background on our experience of managing volatility in emerging markets. Chetan Sehgal, lead PM on TEMIT and I have both been managing emerging market strategies for over 25 years. I started my career in October 1994, 3 months prior to the peso crisis in Mexico and I then spent the first 5 years of my career involved in balance of payment and currency crises, cumulating in the Russian crisis in 1998/99. So, we're both experienced in investing through highly volatile periods and I think this has helped us remain calm in the current crisis. There's no panic within the team. We recognise that this period will pass and that things will recover. The resulting environment may look very different, and we'll discuss that later, but things will recover.

In addition to our personal experience, the way that our research team is organised also means that we have endured little disruption in our day to day operations. Yes, more of us are working from home than is normally the case, but we're a large team located in 16 countries globally, across multiple time zones so we're very accustomed to working from home at random hours of the day and our IT infrastructure and digital connectivity is first class. So there has been no impediment to the effective management of TEMIT during this period.

Indeed, I've always talked about our well-resourced, locally-based team as a key competitive advantage and it's certainly been helpful having a team on the ground in Hong Kong and Shanghai for example, to help us better understand what's happening on the ground in China.

Just to give you a flavour of this, our teams in Hong Kong and China have held more than 500 meetings/calls with companies and industry specialists since the outbreak began.

Portfolio Positioning Before the Crisis

Before talking about the current environment, I wanted to briefly discuss how we were positioned going into this crisis, however I need o remind you that past performance is not a guide to future performance, particularly over short-term periods.

At the start of the year, the portfolio reflected our investment philosophy of investing in competitively advantaged, well managed companies, with sustainable earnings power at attractive valuations. The portfolio had a higher ROA/ROE [return on assets/return on equity] than the MSCI Emerging Markets Index, not achieved through excessive leverage, but superior growth to the index and not at any price, in fact, at a small discount on earnings and cash flow multiples. It is these characteristics that have supported TEMIT's strong performance over recent years and through to end of February.

Coming into the crisis, TEMIT's portfolio was outperforming the index after fees by a small amount, so overall, we felt that the portfolio was in a reasonably good place.

Recent weeks, however, have been very volatile as the virus has swept the globe. Economic activity across emerging markets has come to a halt, currencies have weakened, and equity markets have fallen.

The MSCI Emerging Markets Index was down around 10% for the month to date (as at the close of business on Tuesday 24 March) in sterling. These month to date moves mean that emerging markets are down around 20% from their January highs.

TEMIT is behind the MSCI Emerging Markets Index (after fees) although volatility remains high and that can easily change in a couple of trading days. For example, we've seen absolute moves of plus 8% and down 4% in the Index in the last two weeks. So effectively we're seeing indiscriminate moves in markets with fundamental factors having little impact on where stocks are trading.

Recent Performance Drivers

In terms of recent performance drivers, TEMIT has seen weakness in a number of the banks that we own, particularly those names we hold in India and Brazil, for example ICICI Bank in India and Itau Unibanco in Brazil are down 35% and 30% respectively month to date, and these are both very sound, well managed banks. We've also seen weakness in consumer facing names, those most impacted by the sudden collapse in consumer activity, such as sportwear brands, auto manufacturers and casino operators.

With the oil price falling over 40% month to date, we've also seen weakness in our Russian holdings following the collapse in demand and the surprise breakdown of the supply agreement between Russia and Saudi Arabia. For example, Lukoil, one of the country's leading private sector oil companies is down over 25% month to date and Sberbank, the country's dominant bank is also down 25%.

Conversely, the portfolio has benefited from our underweight position in materials, real estate and industrials.

We benefited from our holdings in technology names, especially Tencent, the Chinese gaming and messaging platform that has been a significant outperformer this month. We've also benefited from our holdings in Naspers and Prosus that both have indirect exposure to Tencent.

Elsewhere in China, our holding in Brilliance China, BMWs Joint Venture partner in China has also performed well.

Portfolio Activity

As I mentioned earlier, our approach has been calm and rationale, there is no panic.

Going into this crisis, our portfolio was well diversified. With our stocks reflecting our philosophy of owning good quality businesses, with long-term sustainable earnings power at a discount to intrinsic worth. Our positioning is in well capitalised companies and we are cognisant of leverage with a clear preference for low or appropriately levered companies. Hence, we have not made significant changes to the portfolio on account of the crisis.

We have however raised cash to neutralise the leverage in TEMIT. As a reminder we have a £100 million loan facility, which equates to a 5% leverage ratio and we felt it prudent to raise cash to offset this leverage given the highly volatile nature of markets in the short-term. Our ambition remains to use this leverage to enhance long-term returns for investors.

Elsewhere, what we have done is to exit or reduce a small number of positions in companies where we believe there is a longer-term negative impact on the business or where share prices have not corrected in line with the expected negative impact on the business. So, for example, we sold China Construction Bank, that's one of the largest state-owned banks in China, and the stock's held up really well year-to-date. We believe that the Chinese state banks will probably have to share a burden of the impact on the Chinese economy due to the virus outbreak. We don't think that's necessarily reflected in valuations today.

We have also reduced our exposure to MGM China, a casino operator in Macau, where we believe that demand recovery will take some time and we have instead focused our casino holdings in Nagacorp, the Cambodian operator which we believe is better placed competitively over the long- term.

Portfolio Activity (continued)

Before the onset of the crisis we had also reduced weightings in some of our Brazil non-bank holdings, primarily on strong performance and high valuations.

In terms of adding names to TEMIT, we haven't initiated any new positions in this period. However, we have been using this opportunity to add to our existing high conviction portfolio holdings, which have seen significant correction. Some of the key additions have been in Brazilian banks, Chinese internet stocks and the Chinese telecom sector. We have also added to Samsung Life, the largest life insurance company in Korea. While the stock's performance has been weak this year, we are confident on recovery, given cheap valuations, strong prospects of its key holding, Samsung Electronics and our expectation of an improvement in shareholder returns.

Whilst the immediate outlook for the global economy remains highly uncertain and it is difficult to assess negative impact on growth and corporate earnings in the short-term, we believe that our focus on long-term sustainable earnings power should help us better navigate coming months and over time, we expect the long-term fundamentals of our holdings to remain intact. More specifically, we're invested in companies that are both (a) exposed to areas of structural growth and (b) have got scope to gain a higher share of the total addressable market and their competitive advantage, whether that's their free cash flow generation capability, their existing market share where they dominate their respective industry, or technological leadership. So, we believe we're focused on the right types of businesses for this environment.

The Questions the Managers Are Asking Themselves

The questions we're asking ourselves center around a number of things:

Firstly, the impact on supply chains of key technology, healthcare, and other products, and the degree to which end customers and companies are willing to pay more for greater security of supply.

Secondly, we're looking at the degree and duration of demand destruction in the developed economies from the outbreak of this virus, and we're looking at the likely policy response from authorities globally, and the impact this has on the sustainability of sovereign balance sheets. We know that going into this crisis, the developed world typically had too much debt, so we should expect in the post-crisis world these imbalances to be further exacerbated by government policy. Similarly, pre-crisis, we saw an historic spread between style factors and the outcome of the crisis may be a continued bias towards growth equities, further away from value.

Finally, we're going to be searching for companies that could benefit from any permanent behavioural changes in society, and we think that technology is more and more likely to be strongly embraced, so we'll see further penetration of e-commerce, more use of e-learning, and the major question we'll be asking ourselves, does social distancing become more normalised and what does this imply for how we interact in various consumer facing business models. So, there's plenty for us to get stuck into overcoming months.

The Questions Shareholders Asked

What's happening in China? Are things recovering because we do see anecdotal reports of that being the case?

Well, as I mentioned earlier, we get regular updates from our team on the ground in China, and yes things do seem to be normalising. Overall consumption is getting back towards 80-85% of normal. Online spending looks like it's back to normal levels. Now, clearly, that's been supported by people being at home, so we're seeing much more online activities, benefitting the likes of Alibaba and Tencent.

This outbreak came about during Chinese New Year when many people travelled home to their local villages and they had, ultimately, been stuck there, but we've seen migration trends picking up and factory workers returning to work. Factories are opening again, and manufacturing activities are expected to fully normalise in the next two to three weeks.

Those sectors most negatively impacted in China, however, the likes of car sales and home sales, travel and restaurants have certainly been slower to recover, and I would remind you that there's still no vaccine to the virus, and China, like most other countries, will have to go through periods of continued social distancing policies until we get to fully normal behaviour.

Another point of caution is that whilst China may be getting back to work, the rest of the world is going into lockdown, so whilst the supply of manufactured goods may no longer be a problem, we're still going to have a significant demand shock in the short-term to deal with.

Could you discuss the oil exposure and the impact of the price collapse on your Russian holding?

So, the breakdown of the OPEC+ negotiations really resulted in a sea change in OPEC+ policy. The key producers, Saudi Arabia and Russia, effectively shifted from a strategy of cutting production to maintain pricing towards ramping up production and focusing on market share. You can see that by Saudi's big aggressive price cuts across the board. This was very much an unexpected outcome and led to significant weakness in crude prices, with Brent now down from $68 in early January to $27 today.

Could you discuss the oil exposure and the impact of the price collapse on your Russian holding? Cont.

Going into this oil crisis, TEMIT was neutral in the energy sector, our preferred exposure in terms of oil sensitivity was in Russia and Russian stocks, and we had no exposure to other oil-sensitive markets like Colombia, Saudi Arabia, Qatar, and the UAE. Our preference for Russia was that Russian stocks remained very attractively priced. The market was trading around about seven times earnings. It was offering one of the highest yields in global equity markets, over 8%. The country has very little sovereign debt, has twin surpluses in both current account and fiscal balance, an extremely enviable position to be in.

Since 2017, there's been a shift in how the fiscal reserves work with the price of oil, and it has created a stabilisation system, that's allowed the country to build up considerable FX reserves. You've got $570 billion now in FX reserves, that's equivalent to 33% of GDP. They've built a National Wealth Fund, diverting fiscal earnings from periods of high oil prices into the National Wealth Fund entirely for periods of lower oil prices. This allows stabilisation of the economy, and that wealth fund is now an equivalent of 8% of GDP, and most Russian oil companies, they're free cash flow positive even at $20 oil.

Russia is very well prepared for a low oil price environment. As many of you know, this is a stark contrast to other crude producers globally. The majority of US shale producers are loss making at $30. Obviously, quite a high percentage of these have hedged themselves, and they will continue to produce until hedges run out in what's expected to be six to nine months. But, ultimately, they will need higher prices after that.

Also, Saudi Arabia can wage a price war for several months, up to a year given their ample reserves and their moderate debt to GDP ratio, but ultimately, Saudi is limited given its high fiscal reliance on oil. I think their fiscal breakeven is around about $83-84. This price war is coming really an inopportune time for them, given that the Government is trying to launch several large-scale domestic projects, as well as trying to protect its citizens from fiscal austerity.

Longer-term, we're likely to see a supply response with the higher cost US shale producers effectively having to shut down production, and this should ultimately lead to higher oil prices at some point in the future.

Now, in terms of our portfolio impact, a key name in TEMIT's portfolio holdings has been Lukoil, and that very much benefits from its strong balance sheet and its generous dividend policy. I had a conference call with management just yesterday, looking for an update, and they sounded fairly relaxed, incredibly so, given what the price of oil has done.

The reason for that is very much the fundamental strength of the business. Their net leverage [debt] is zero. They've got very effective natural hedges to lower oil prices, that they operate in a very progressive tax regime environment. Ultimately, when the oil price falls, it's the Government that bears the cost of that, and their margins are almost unchanged. Now, in addition to that, they've got the majority of their costs in roubles, so when the currency weakens with lower oil prices, their margins are broadly unchanged.

We also own CNOOC in China [*China National Offshore Oil Corporation*], and that company's costs are less than $30 per barrel, so as such, we assume that CNOOC can continue to earn positive, albeit small profits over the course of this year, and given their cash on balance sheet, we still believe they're able to support a dividend and also fund capital expenditure for future growth.

Not all oil impact is negative. Clearly, from a macro perspective, there's many emerging markets – and specifically in the Asian region – that are net oil and gas importers. Lower oil prices should ultimately support downward pressure on inflation. That will help policy makers have more flexibility, for example, in monetary easing to cushion the growth particularly in countries like India, China, Indonesia, and the Philippines. So, a lower oil price is not necessarily all bad news.

Where are emerging markets valuations after the correction? Are markets now cheap?"

Difficult to say, there's been so much movement. Markets are highly volatile. Earning downgrades, they're inevitable but, typically, come with a lag.

So, if we look at the end of last week, it looked like emerging markets were trading at around about nine times forward earnings and that's versus the 15-year average of just over 11 times. Price-to-book, the asset class is on a trailing basis, we're at 1.2 times and, again, that was against a 15-year average of about 1.8 times. We're looking cheaper than we were a few months ago, but these figures, clearly, have been lower in previous crises. Although it's fair to say if you look at the global financial crisis and all the crises that I experienced as a younger man, the composition of asset class was very different back then, so I'm not sure we're necessarily comparing like-for-like.

Earnings-wise, we would expect to see significant downgrades for 2020 earnings across most countries and sectors, although our assumption is, clearly, that this virus outbreak does pass, then we would expect to see a significant earnings recovery at some point in the future.

So, a difficult question to answer with precise detail, but net-net, valuations look more appealing than they have for some time, although we should see significant volatility in earnings forecasts over coming months.

You mentioned weakness in financials, what are you doing in response to that? Are you still confident in the names that you hold?

Interesting, and I'm just reading headlines today from Hungary where they're applying a moratorium on all bank debt, both corporate and retail for the end of the year. Now, that's probably one of the more aggressive interventions we've seen in the banking system. Many countries, the UK included, will be supporting borrowers through this period, understandably. Some of that burden will be borne by the fiscal systems, some will be borne by the banking system, so banks have understandably come under scrutiny during this selloff.

Some of our banks, as I mentioned earlier, have been very weak. I talked about the Indian and Brazilian names that we own. However, we don't see high probabilities of systemic banking crises in the majority of our markets. I've been seeing lots of our clients over the last 12-18 months and talking about this at length. We've been through balance sheet crises in past decades, so as a consequence, our banks are much better capitalised than they've been any time in my investing career. Regulators have been doing a good job on oversight and supervision.

But most importantly, in many markets, we've not seen booming credit markets. Remember, the world economy hasn't been firing on all cylinders for a number of years, and if you look to Brazil, for example, the banks that we own there, they've effectively been de-risking their balance sheets for the last seven or eight years, due to the domestic recession in Brazil. Our banks are, typically, in good condition to deal with this crisis.

Now, obviously, there's going to be negatives. Given the collapse in economic activity, there will be negative impact on credit in these economies, so we should expect slower loan growth. Bad assets and impairments will rise. Banks may also be called upon to do some public policy in certain economies, and I think that that will vary from country to country. Now, all of that will have a negative impact on profits in the short-term. However – and again this is our working assumption – this crisis will pass, and we believe that our banks remain well positioned to resume growth, given the attractive and low levels of credit penetration across the asset class.

Just finally, one of the interesting topics we're discussing as a team, and was raised earlier this week from Gus, who is, a portfolio manager in Rio de Janeiro, we think that this crisis will shake out much of the new FinTech competition that we've seen emerge in recent years, because if you look at those business models, they're typically high cash burners with weak liability franchises, and our incumbent banks that we typically own, they've got strong capitalisation levels, as I mentioned earlier, they've got very robust deposit franchises, so sticky relationships with their clientele. On the retail side, they're typically deposit banks that are receiving payrolls from their customers, so that's a very sticky banking relationship, as we will all know. Our banks, with these franchises, should therefore emerge, we think, in a more competitively advantaged position once this crisis has passed.

That's one of the points I was making earlier that we believe the world will look different as we get through this. Part of the research agenda we have over the coming months is to better understand what those differences look like. I think, within the banking system, the empowerment of well-franchised and capitalised incumbents is certainly something to note.

Unfortunately, we've run out of time, I would just like to thank Andrew for his very comprehensive update and to wish you and your families well. We hope that you will keep safe and we look forward, as Andrew said, to this challenging period passing.

Thank you very much.

Opinions expressed are the author's at publication date and they are subject to change without prior notice.

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TEMIT invests in the equity securities of emerging markets companies. Emerging markets have historically been subject to significant price movements, often to a greater extent than more established equity markets. As a result, the share price and net asset value of TEMIT can fluctuate significantly over relatively short time periods.

Other significant risks include borrowing risk and share price discount to NAV risk. For more details of all the risks applicable to TEMIT, please refer to the Key Information Document, Investor Disclosure Document and the risk section in TEMIT's Annual Report, which can be downloaded from our website – www.temit.co.uk

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